

THE SOFTWOOD LUMBER WAR

**Politics, Economics, and the
Long U.S.-Canadian Trade Dispute**



Daowei Zhang

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Long U.S.–Canada Trade Dispute*

DAOWEI ZHANG

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To my parents

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List of Abbreviations

| | |
|-------|----------------------------------------------|
| bbf | billion board feet |
| FTA | U.S.–Canada Free Trade Agreement |
| GATT | General Agreement on Tariffs and Trade |
| GDP | gross domestic product |
| ICC | Interstate Commerce Commission |
| ITC | U.S. International Trade Commission |
| mbf | thousand board feet |
| MLA | member of the legislative assembly |
| mmbf | million board feet |
| MOU | Memorandum of Understanding (signed in 1986) |
| NAFTA | North American Free Trade Agreement |
| PPI | producer price index |
| USTR | U.S. trade representative |
| WTO | World Trade Organization |

Foreword

When I moved to Canada in 1990 to become the dean of the Faculty of Forestry at the University of British Columbia, my fine Yale University colleague, Robin Winks, sent me off with some good advice. He gave me a copy of Seymour Martin Lipset's book *Continental Divide* and commented that any American moving to Canada should be very careful about assuming the countries were similar ("two countries separated by a common language," I think he said). Lipset argues that the American Revolution founded not one country but two, which despite their common roots have developed along somewhat different lines. Those favoring "peace, prosperity and good government" moved north to British North America, which became Canada, and those favoring "life, liberty and the pursuit of happiness" stayed south of "the line."

Nowhere is the divergence greater than in the western part of the continent. U.S. policy moved public land quickly into private ownership, individual and corporate. It was almost an afterthought to retain public ownership of the mountainous forest land remaining after railroads and homesteaders had selected the best parcels. In contrast, the western provincial governments of Canada kept land, especially high-quality forest land, in public ownership. Canada used timber as a wooden magnet to attract capital investment in manufacturing facilities as a means of securing economic prosperity for towns in rural Canada. Timber was allocated via administrative processes, unlike the situation in the United States, where markets generally prevailed. The Canadian lumber industry has prospered under these policies and now supplies roughly one-third of U.S. consumption.

Those structural differences in forest ownership and timber supply promoted misunderstandings. Parties on both sides of the border have used incomplete or erroneous characterizations of the other's system for their own political and economic ends—most prominently in the case of softwood lumber trade, with the United States imposing its first tariffs in the late 1700s.

Of course, the longevity of the modern softwood lumber dispute has its roots in causes far more powerful than simple cultural misunderstanding. Concentrated economic interests can use political processes to further those interests to the detriment of the larger public good. So it is with softwood lumber producers in the United States. They have effectively used U.S. trade legislation to impose restrictions on Canadian lumber imports into the United States. These restrictions have been implemented through a variety of mechanisms—tariffs, quotas, tariff-mediated quotas, and export fees in Canada. The economic effects are more or less the same, with reduced imports from Canada increasing lumber prices in the United States. U.S. producers and most Canadian ones benefit from higher lumber prices in the United States, to the detriment of U.S. consumers. Forest owners—provincial governments to the north, corporate and individual private landowners to the south—also benefit indirectly because higher lumber prices generally translate into higher prices for standing timber.

The fact that lumber trade restrictions take money from U.S. consumers and give it to Canadians has not been lost on Canadian interests—what better than a U.S.-initiated policy that benefits Canada? Throughout the three decades of the most recent round of disputes, the Canadian federal government, provincial governments, and forest products industry have squabbled over who should reap the benefits of trade restrictions.

This cheerful (for some) view of the softwood lumber dispute depends on a static analysis of markets. Thoughtful participants have come to understand that few of the major factors involved in this dispute remain unchanged, particularly over periods measured in decades. In Canada, the various trade agreements have thwarted the very reforms that U.S. interests are nominally seeking—market-based allocation of timber; tenure reforms to create more private and private-like forest land; free trade in logs. Restrictions on the import of Canadian lumber into the United States have created an opening for non-Canadian imports—especially from Latin America and Europe—that come into the States without the impediment of duties. Because lumber demand is quite inelastic in the short run, this surge in non-Canadian imports quickly reduces prices from the levels that they would otherwise attain and offsets much of the advantage U.S. lumber producers gain from restrictions on Canadian imports.

Political ideology in the United States celebrates free trade in instances where subsidies do not distort comparative advantage. As a result of this core political foundation, the persistence of the softwood lumber dispute is surprising. Repeated rulings by trade panels of the North American Free Trade Agreement and World Trade Organization reject the U.S. charges of Canadian subsidy and injurious practice. The one remaining exception is the restriction on log exports from coastal British Columbia, and even this policy appears to be open for reconsideration by Canadian participants. Is now the

time to think the unthinkable and do the undoable—create free trade in lumber and logs in North America?

The puzzle is why two countries as closely tied as the United States and Canada have not been able to find a sustainable, mutually acceptable approach to reaching this conclusion. Zhang provides the analytical framework for understanding the puzzle, and, therefore, perhaps for resolving it. His balanced, even-handed analysis draws on history, law, politics, economics, and institutional setting to provide a remarkably comprehensive treatment of one of the longest standing trade disputes in the world. Not only is his book the definitive account of this trade dispute, but it also casts useful light on the larger questions of U.S.–Canada trade and globalization itself.

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Clark S. Binkley is the former dean of the Faculty of Forestry at the University of British Columbia. He currently is the managing director of International Forestry Investment Advisors, LLC, a private firm that provides timberland investment advisory services. He serves on the board of directors of West Fraser Timber, the second-largest softwood lumber manufacturer in North America, with operations in Canada and the United States, as well as on the board of directors of TimberWest Forests, the largest private forest landowner in Canada. He is a citizen of both the United States and Canada.

Preface

As a forester interested in economics and policy matters, I have followed for nearly 20 years the perennial dispute between the United States and Canada over softwood lumber trade. The dispute, the largest and longest running between the two otherwise friendly countries, has frustrated politicians and business leaders on both sides of the border and has earned the nickname “The Softwood Lumber War.” This book is about the political economy of the softwood lumber trade dispute, which has been a constant struggle among U.S. lumber producers, U.S. consumers, and Canadian producers in the last two and a half decades.

The early 1980s was a difficult time for U.S. lumber producers. They experienced an economic recession and the collapse of softwood lumber prices as the result of a change in macroeconomic policy (restrictive monetary supply) in October 1979. Some Pacific Northwest producers had previously submitted high bid prices on public timber that they could not afford to pay in the new economic environment. Concurrently, they saw their domestic market share increasingly taken away by Canadian producers. At this juncture, some of the Pacific Northwest producers requested (and obtained in 1984) federal relief from their timber purchase contracts signed several years previously and sought government restrictions on Canadian lumber imports, alleging that Canadian lumber was subsidized.

Despite initial failure, U.S. producers continued to apply political pressure and eventually secured a 15 percent export tax on Canadian lumber under the 1986 Memorandum of Understanding between the two countries. As a result, Canadian producers’ costs were increased, their U.S. market share declined, and lumber prices rose in the United States. The successful negotiation in October 1987 and implementation in January 1989 of the U.S.–Canada Free Trade Agreement gave Canadian lumber producers a chance to fight back by withdrawing from the memorandum of understanding. A long series of

controversial trade battles followed against the background of periodic shortages of timber supply in the United States, changing international lumber markets, overcapacity in lumber manufacturing, and the establishment of the North American Free Trade Agreement and the World Trade Organization. It is this story—how a rather large trade dispute was prolonged by politics, economics, legal structures (technical details as well as broader principles involved in U.S. and international trade laws), and institutional arrangements—that I tell here. Furthermore, I identify issues that have contributed to the longevity of the dispute and explore how they might be used more universally in the realm of natural resource management and international trade.

Over the past 18 years, I have studied the Canadian forest tenure system in which the alleged subsidy is rooted. I have also written refereed articles directly or indirectly related to the softwood lumber dispute. These articles have been cited by opposing sides of the dispute in support of their arguments. For example, U.S. consumer groups cited my study on the welfare costs of the 1996 U.S.–Canada Softwood Lumber Agreement to the United States as a whole and to U.S. lumber consumers in particular. The same study was quoted by the Coalition for Fair Lumber Imports, the primary U.S. industry group lobbying for restricting Canadian lumber imports, in its submission to the U.S. International Trade Commission, for a different purpose. My paper questioning log export restrictions in British Columbia was cited by the coalition as a background paper. The fact that my work has been used by opposing sides buttresses my effort here: to examine and analyze the dispute from an analytical, political, and economic perspective. By documenting various episodes in the war, I hope to use the interplay of politics and economics to explain its longevity, to provide an understanding of why various trade dispute settlement mechanisms have not been able to settle the dispute, to offer some insights on possible solutions to the dispute, and to inform a better understanding of international trade, globalization, and resource management.

Any success I may have achieved is shared with others. Auburn University provided me with a half-year of sabbatical leave that allowed me to do largely uninterrupted research on the subject. U.S. Forest Service George Andrew Forest Products Laboratory provided me an office in 2005. Dr. Clark S. Binkley, who graciously wrote the foreword for this book, supported my study on forest tenure and this project in all stages. Many industry insiders and lawyers have given their time for my interviews and insights on the subject. The National Research Initiatives of the Cooperative State Research, Education, and Extension Service, USDA (Grant 99-35400-7741) provided financial support for my earlier research on the subject.

I would also like to express my appreciation to the following people for their collective and individual assistance: to Rao Nagubadi and Yanshu Li for research assistance and reading of the first draft of this book, to Lisa Jones of Ronald Reagan Presidential Library and Ken Hildebrand, George Brandak, and Kather-

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Finally, I would like to acknowledge my appreciation for my family. My parents, Qingxian Zhang and Jiao You, to whom this book is dedicated, are illiterate farmers in China. They sent three of their four children to college and one through high school. Their inspiration and encouragement to me are invaluable. My wife, Zilun Fan, has supported my effort throughout this project, and our children, Rei and Dan, have missed some playing time with me.

DAOWEI ZHANG

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A War between Friends

With the implementation of the 2006 U.S.–Canada Softwood Lumber Agreement on October 12, 2006, the quarter-century-long softwood lumber trade dispute between the two countries officially takes a pause. Aside from leaving in the United States some 19 percent of the US\$5.4 billion duty deposits that Canadian producers said should have been returned to them, this agreement sets up managed trade of softwood lumber between the two countries for the next seven to nine years; Canadian lumber exports will be taxed on an increasing scale as lumber prices fall. If previous lumber trade agreements, signed in 1986 and 1996, serve as a guide, however, the Softwood Lumber Agreement of 2006 will not end the trade dispute. At best, it is a short-term mechanism that does little to resolve continuing trade frictions.

This book is about the political economy of the softwood lumber trade dispute between the United States and Canada. The modern version of the dispute has been going on for nearly 25 years, and no long-term, durable solution has been found. Since the value of softwood lumber trade currently exceeds US\$7 billion annually, this disagreement easily ranks as the largest trade dispute between the two countries in the modern era, and its longevity has defied many seasoned observers. Some insiders call the dispute a softwood lumber “war.” Others who have studied it predict that the dispute could persist for another decade or more. How to break the deadlock? Is there a durable and long-lasting solution that is politically feasible in both countries?

The United States and Canada have usually enjoyed good diplomatic, political, and economic relationships, and the forest industry in the two countries has been somewhat integrated through cross-border investment and ownership of forest land and forest products manufacturing facilities. Certainly the softwood lumber dispute has, at times, had the attention and intervention of the highest elected officials—presidents, senators, and members of the House of Representatives in the United States, and prime ministers, members of Parliament, and provincial premiers in Canada—as well as industry leaders and corporate executives.

utives in both countries. Yet none of them have been able to break the deadlock and find a long-lasting solution. Moreover, as we will see, the Softwood Lumber Agreement of 2006 does not end the dispute, even though it took more than five years to negotiate. What are the lessons from the conflict and its duration? Is this lumber dispute a rare example of official discord between the two countries? To the extent that it is exceptional, why is it exceptional?

A trade dispute of such size and longevity is interesting in its own right, and so is the search for an economic, political, and legal explanation. That search may provide insights into the strange coexistence between cooperation and liberalization—political, diplomatic, and economic integration under the U.S.–Canada Free Trade Agreement (FTA) and the North American Free Trade Agreement (NAFTA)—and discord, exemplified by softwood lumber and other trade disputes. A compelling explanation for Canada's desire to have an administratively set pricing system for its timber resources and American producers' ability to curtail Canadian softwood lumber imports may give clues about why the lumber dispute is an exception in U.S.–Canada relations and ways to secure a lasting solution.

Moreover, insights generated from the lumber dispute may help solve other current and future disputes between the two countries over trade in, for example, corn, sugar, potassium, and certain steel products. The softwood lumber trade dispute has run its course, mostly under FTA, NAFTA, and the World Trade Organization (WTO). Why have the trade dispute mechanisms under these binational and multinational arrangements not been able to solve the problem? Can these mechanisms be strengthened to deal with large trade disputes such as softwood lumber?

Finally, many developing countries that have liberalized their economies in recent decades and are relatively small economic powers may face daunting protectionism when they try to sell their products to the United States, Canada, Japan, the European Union, or other developed countries. A better understanding of the U.S.–Canada softwood lumber trade dispute may help these countries deal more effectively with market access and potential protectionism in the United States and elsewhere. To the extent that the lumber dispute has something to do with the disparate economic and political power between Canada and the United States, the experience of Canada, as a developed nation, can be instructive for developing nations.

The remainder of this chapter provides a brief history of the softwood lumber trade dispute, highlights six puzzles related to the dispute, and presents the objectives and organization of this book.

A Brief History

The central issues of the modern softwood lumber trade dispute have been whether Canadian lumber is subsidized, mainly through provincial stumpage

systems, and if it is, whether the U.S. lumber industry is injured or threatened with injury. When these two questions are answered affirmatively by the U.S. Department of Commerce (the actual investigation is carried out by the department's International Trade Administration) and the U.S. International Trade Commission, respectively, a countervailing duty is applied to offset the subsidy. Four phases of the dispute can be distinguished.

The first phase, "Lumber I," officially began on October 7, 1982, when the U.S. Coalition for Fair Canadian Lumber Imports, on behalf of some 350 U.S. lumber producers, filed a petition to the Department of Commerce alleging that certain softwood lumber products from Canada were subsidized by the Canadian government and especially by provincial governments, which own most forest lands in Canada and sell timber harvesting rights through "below-market" stumpage fees. The coalition therefore requested imposition of a countervailing duty against Canadian softwood lumber imports. After investigation, Commerce determined that the alleged below-market stumpage fees were neither provided to any specific industry or group of industries nor offered at preferential rates. The department concluded that the stumpage programs did not qualify for a countervailing duty and that other Canadian programs that were indeed subsidies provided only a *de minimis* (less than 0.5 percent) benefit to Canadian lumber producers (DOC [Department of Commerce] 1983). This marked the end of Lumber I.

In May 1986, in a different political climate in Washington, D.C., and after the Department of Commerce indicated that it had reinterpreted the subsidy protocol for government programs such as Canadian stumpage, a renamed Coalition for Fair Lumber Imports petitioned to reverse the finding in Lumber I. In October 1986, Commerce issued a preliminary determination that Canadian softwood lumber benefited from government subsidies, and the U.S. International Trade Commission preliminarily found injuries to domestic lumber producers. As a result, a 15 percent countervailing duty was immediately placed on Canadian softwood lumber bound for the United States, contingent on a final determination to be made by December 30, 1986 (DOC 1986b).

However, the final determination was averted, and the countervailing duty was never implemented. Instead, the United States and Canada signed a memorandum of understanding (MOU) that transferred collection of the proposed countervailing duty by the United States to the collection of an export tax by Canada. The memorandum allowed provincial governments to increase their stumpage fees in lieu of the full export tax. The policy, applied as either an export tax or a stumpage fee adjustment, was designed to increase the costs of Canadian lumber and reduce any Canadian competitive advantage arising from the alleged subsidy (Wear and Lee 1993). The MOU did not have a termination date, although either country could withdraw from it by giving the other country one month's notice. The period during which the MOU was created and honored is referred to as Lumber II.

On September 4, 1991, the Canadian government notified the U.S. government that it would withdraw from the MOU one month later, as it had honored and would continue to honor all its commitments. The U.S. government immediately self-initiated a countervailing duty investigation and imposed an interim duty for much of 1992 and 1993, arguing that without the memorandum, there was no mechanism to verify promises by the Canadian government. Canada challenged the U.S. decision under the FTA dispute settlement mechanism, which resulted in free trade of softwood lumber in 1994 and 1995. In April 1996, the two countries signed the Softwood Lumber Agreement, which was a tariff-rate quota system restricting Canadian lumber imports to the United States. The quota system was later found to have the same impact on lumber prices as an 11.6 percent export tax. This period is referred to as Lumber III.

After the expiration of the 1996 agreement on March 31, 2001, the Coalition for Fair Lumber Imports requested another countervailing duty investigation; this marked the beginning of Lumber IV. An antidumping component was added to the investigation. In May 2002, the United States imposed an average 18.79 percent countervailing duty and an average 8.43 percent antidumping duty, or 27.22 percent in total on Canadian lumber imports; company-specific duty rates were assessed and then modified annually under the Department of Commerce's annual administrative review. Canada challenged the U.S. decision at WTO and NAFTA. Canada won several major legal cases in both international bodies, especially under NAFTA, while the United States had some success at WTO. In particular, a NAFTA panel ruled in October 2004 that Canadian lumber imports did not threaten to injure the U.S. lumber industry. The United States challenged that panel's decision at a NAFTA Extraordinary Challenge Committee, which affirmed the panel's decision in August 2005. In March 2006, another NAFTA panel ruled that Canadian lumber was not subsidized. The United States had not complied with the NAFTA rulings, arguing that NAFTA panel decisions were only prospective and that its domestic trade laws were consistent with the WTO rules.

In the meantime, several rounds of negotiations between the governments of the two countries and industry failed to generate an agreement, either a short-term deal or a long-term solution, for five years. The breakthrough occurred in April 2006, after heads of state from the two countries made a political commitment to strike a deal; the Softwood Lumber Agreement of 2006 was signed on September 12, 2006, and implemented one month later.

Six Puzzles

In recent years, the United States and Canada have signed bilateral and multi-lateral free trade agreements such as FTA and NAFTA. They are also major supporters of the General Agreement on Tariffs and Trade (GATT) and WTO. Trade between these two countries in general has become freer. Many tariff and

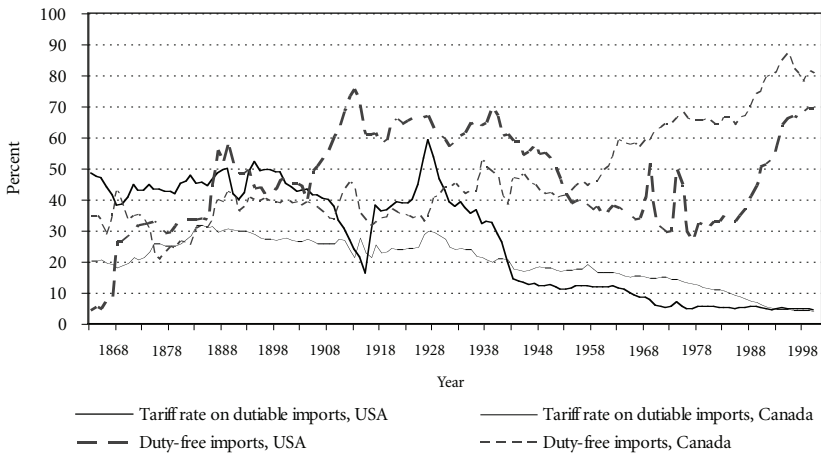


FIGURE 1-1. Tariff Rate on Dutiable Imports and Share of Duty-Free Imports in the United States and Canada, 1868–2005

Note: Data for Canada prior to 1888 were from Statistics Canada (2003). Except for 1997, data for Canada used in this graph between 1888 and 2005 were not available and had to be estimated. According to Foreign Affairs and International Trade Canada (1999), Canada's tariff rates on dutiable imports declined from 11.28 percent to 5.03 percent from 1987 to 1997. The tariff rates on dutiable imports and percentage of duty-free imports between 1888 and 1996 were subsequently estimated using an interpolation (linear average) method. For the years between 1998 and 2005, Statistics Canada (2007) shows the average tariff rate on total imports was 0.81. Because the tariff rate on dutiable imports was five times that on total imports in 1997, multiplying 0.81 by 5 produces an approximate tariff rate on dutiable imports for 2005. Using the tariff rates on dutiable imports for 1997 and 2005, the tariff rates on dutiable imports for Canada between 1998 and 2004 were interpolated using the linear average method.

Sources: Statistics Canada (2003); U.S. Bureau of Census (1975); ITC (2006a).

nontariff barriers have been reduced or eliminated. In 2005, both countries admitted some 70 percent of total imports duty free. The U.S. general tariff rate, measured as the share of tariffs on all dutiable goods, has declined steadily in the past century. The overall tariff rate was about 5 percent in recent years, less than a tenth of the peak reached in 1933 that resulted from the infamous Smoot-Hawley tariff. Canadian tariff rates also trended downward (Figure 1-1).

Tariff reductions and eliminations have led to a dramatic increase in international trade in recent decades. In 2005, the value of U.S. and Canada bilateral transactions in goods, services, and income payments reached US\$613 billion, roughly tripled from 1988 (Figure 1-2).

Those tariff reductions did not apply to Canadian softwood lumber. U.S. tariffs, Canadian export taxes, or other restrictive measures have been put on Canadian lumber for most of the past 20 years and now extend into the future (Table 1-1).

This is our first puzzle: increasingly free trade for most goods and services but not for softwood lumber. In fact, lumber trade was free (or freer) for

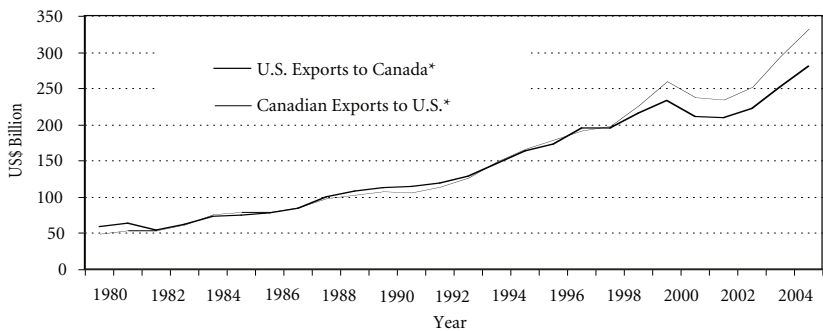


FIGURE 1-2. Total Value of Trade and Income Payments between the United States and Canada, 1980–2005

* Includes income payments.
Source: U.S. Bureau of Economic Analysis (2006).

decades before the end of 1986, when the memorandum of understanding put a 15 percent export tax on most Canadian lumber. Why is softwood lumber different from other goods and services traded between the two countries? What did Canadians do wrong with softwood lumber? If the Canadians did nothing wrong, were the Americans making mistakes by imposing tariffs or other restrictive measures on Canadian lumber imports?

TABLE 1-1. U.S. Trade Restriction Measures on Canadian Softwood Lumber Imports

| Duration | Restriction measure | Magnitude |
|-----------------------------------|--------------------------|-------------------------------------------------------------------------------------------------------------------------------------|
| 1/1/1987–10/3/1991 | MOU | 15% export tax or stumpage adjustment |
| 10/4/1991–2/19/1992 | Section 301 ^a | Lumber from Ontario, Alberta, Manitoba, and Saskatchewan, 15%; lumber from Québec, 6.2% before November 1, 1991, and 3.1% afterward |
| 3/12/1992–5/27/1992 | Interim CVD ^a | 14.48% |
| 5/28/1992–8/3/1994 | CVD ^a | 6.51% |
| 4/1/1996–3/31/2005 | SLA 1996 | Tariff-rate quota |
| 5/19/2001–5/21/2002 | CVD and AD ^b | 19.31–31.89% |
| 5/22/2002–4/31/2003 | CVD and AD ^b | CVD, 16.37%; AD, 3.78% |
| 5/1/2003–10/12/2006 | CVD and AD ^b | CVD, 8.70%; AD, 2.11% |
| 10/13/2006– (for 7 to 9 years) | SLA 2006 | Export tax range from 0% to 15%, or export charge (0%–5%) plus volume control |

Note: MOU = Memorandum of Understanding; CVD = countervailing duty; SLA = Softwood Lumber Agreement; AD = antidumping duty.

a. Bonds or duties were returned to Canada as a result of WTO or FTA panel rulings or Commerce determination.

b. These rates were determined by Commerce’s retrospective annual administrative reviews. The actual duty rates charged for a particular year before the annual administrative reviews were conducted were quite different from these rates. Also, under SLA 2006, some 81 percent of these duties were returned to Canadian producers.

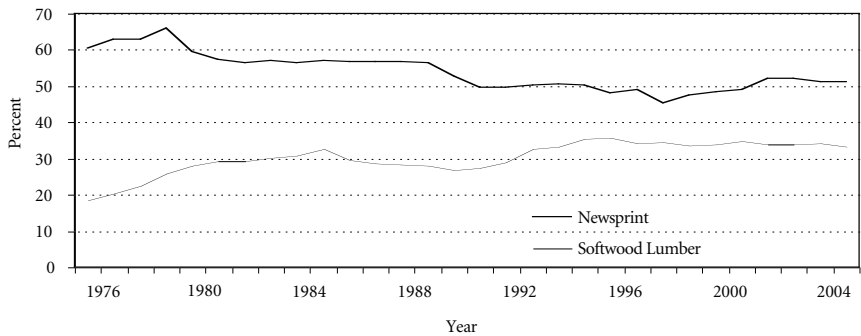


FIGURE 1-3. Share of Canadian Newsprint and Softwood Lumber in U.S. Consumption, 1975–2005

Sources: AF&PA (2006), NAHB (2006).

Our second puzzle is the contrast between forest products: free trade for most forest products but not for softwood lumber, even though they all come from timber. Ostensibly, the initial investigation of subsidy and the subsequent imposition of countervailing duties on softwood lumber were triggered by an increase in the Canadian share of the U.S. lumber market, especially between 1975 and 1982. However, Canadian newsprint has a much larger share of the U.S. market than Canadian softwood lumber. The share of Canadian softwood lumber in the U.S. market has been around one-third in the last decade, while the share of Canadian newsprint has been largely more than 50 percent (Figure 1-3).

One may argue that newsprint and softwood lumber are different in that their supply and demand are not driven by the same forces and that wood constitutes a bigger share in the production cost of softwood lumber than in that of newsprint. However, both lumber and newsprint are made of wood, and wood was the largest component of newsprint production cost in the 1920s, and it is the second largest now. Softwood lumber is made of sawlogs (large logs), and newsprint is made of pulpwood (small logs) and chips that are a residue from lumber production. If the Canadian stumpage system gives subsidies to softwood lumber producers, it should provide them simultaneously to newsprint producers as well. Why was there no complaint about Canadian newsprint imports?

In fact, the United States and Canada fought a series of battles over newsprint tariffs around the turn of the 20th century, and the result has been free trade in newsprint since 1911. Even though these two disputes are some 80 years apart, some lessons may be learned by investigating the importance of political, economic, and institutional factors in determining the outcome of the trade conflicts in forest products between the two countries.

Further, the fact that newsprint is a value-added product yet both it and softwood lumber are imported into the United States in a similar magnitude in value only heightens the contrast between these two trade disputes—since in theory, the United States should impose higher tariffs on newsprint than on

softwood lumber. Instead, the United States has let Canadian newsprint come to the country duty free since 1911 but imposed tariffs, export taxes, or tariff-rate quotas on Canadian softwood lumber. This cannot be explained by the difference in the raw material (wood) cost of these products.

How could the two countries be at relative peace in the newsprint trade for so long? What are the similarities and differences between trade in these two products, and what forces have brought about such different outcomes?

Our third puzzle is why both countries, in the course of the lumber trade dispute, were willing to give up trade arrangements that were clearly in their favor from an economic point of view. From an economic perspective, free trade benefits both economies as a whole, but some constraints on trade flows, including export taxes and quotas, appear to increase social welfare in Canada and decrease welfare in the United States. Yet the U.S. government resisted free trade, and the Canadian government objected to export constraints on its lumber exports. Perhaps the distribution of incomes associated with free trade and trade constraints has something to do with this paradox. More importantly, international politics, institutional factors, and the imbalance of political power among players in both countries may help explain why each country has accepted trade arrangements that are inferior or detrimental to its macroeconomy but favor a particular group—for example, lumber producers.

Our fourth puzzle is why politicians and corporate executives in both countries could not find a durable solution for the softwood lumber trade dispute. The two countries have historically had good diplomatic, political, military, and general economic relationships. With few exceptions, the personal relationships between the heads of states of the two countries have been close. The forests in western Canada and in the U.S. Pacific Northwest are similar; so are the forests in New England and the Great Lakes States and in eastern Canada. Corporate ownership of the forest products industry is somewhat integrated across the two countries, and many firms are members of the same industry associations, such as the American Forest and Paper Association. Politicians and corporate executives are heavily involved in the lumber trade dispute. Are there any inherent, institutional obstacles in either country that prohibit them from finding a long-term solution? Have forest products corporations in both countries given too much control of this matter to their trade lawyers?

Along with trade liberalization in the United States, the application for administered protection by U.S. companies under antidumping duty laws has increased in recent years. According to Department of Commerce statistics, the annual number of investigations initiated on antidumping duty allegations rose from an average of 30 cases from 1980 to 1984 to an average of 48 cases between 1999 and 2003 (Figure 1-4). Similarly, the number of antidumping duty orders issued increased from 4.7 per year to 22.8 per year over the same period. However, the use of countervailing duties declined (Figure 1-5). More specifically, Commerce initiated an average of 27.2 countervailing duty investigations and issued 9.4 such orders per year between 1980 and 1984. By 1999–2003, the num-

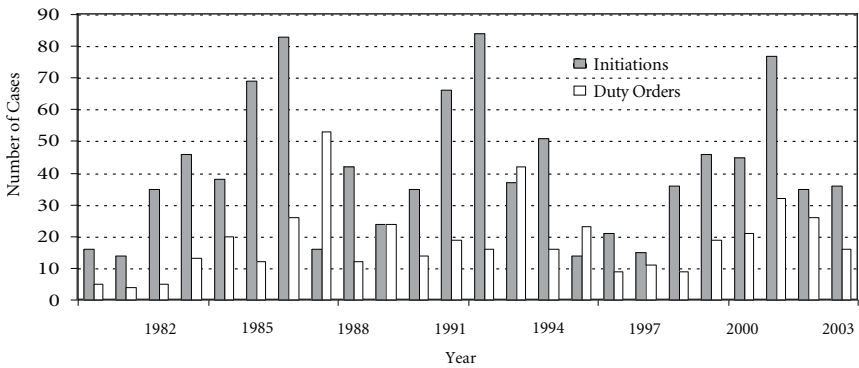


FIGURE 1-4. U.S. Department of Commerce Antidumping Duty Case Activity, 1980–2003

Source: <http://ia.ita.doc.gov/stats/iastats1.html>.

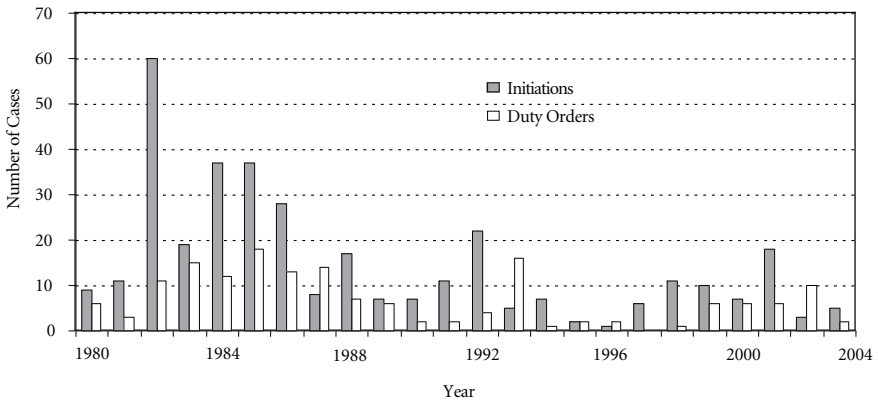


FIGURE 1-5. U.S. Department of Commerce Countervailing Duty Case Activity, 1980–2003

Source: <http://ia.ita.doc.gov/stats/iastats1.html>.

ber of investigations fell to 8.6 and the number of orders dropped to 5.2 annually. Yet in the softwood lumber case, the allegations of subsidy and demands for countervailing duties have persisted for more than 25 years. Here is our fifth puzzle. Have the American lumber producers been crying foul even though there is no lumber subsidy in Canada? Or have Canadian provincial governments, heavily influenced by their own lumber producers, failed to make real changes to their stumpage systems? Or is there some of both?

Finally, the softwood lumber trade dispute has taken place as trade dispute settlement mechanisms under FTA, NAFTA, and WTO have been implemented. Why have these mechanisms not worked effectively to resolve the softwood lumber trade dispute? What can be done to improve dispute settlement mechanisms?

What explains these paradoxical developments? What are the causes of the softwood lumber dispute? How did it start? Why has the dispute lasted so long?

How long will it continue? Are there any long-term and durable solutions? What does the lumber dispute teach us about U.S.–Canada relations, international trade, and natural resource management?

I hypothesize that interest group politics in both countries has a lot to do with these paradoxical developments and might explain the cause, persistence, and intractability of the softwood lumber dispute. Lumber (and other forest products) companies in both countries are rent seeking, and U.S. consumers are welfare maximizing. All three groups have used political means and taken advantage of the legal and institutional settings in the two countries to advance their interests. They have sometimes succeeded in overriding other national interests when they have enough political clout. The dispute settlement mechanisms under FTA, NAFTA, and WTO have some weaknesses and have ultimately failed in solving the softwood lumber dispute when the two governments, driven by interest group politics, are looking for an easy way out.

Given the economic significance of the softwood lumber trade dispute and the truckloads of documents generated from all parties involved, it is surprising to find that, in fact, there has been little comprehensive analysis of the dispute. Percy and Yoder (1987) and Uhler (1991) are somewhat dated, and their views are perceived to be limited to the Canadian side. Other published academic studies focus on individual aspects of the dispute. For example, Adams et al. (1986) write about the currency exchange rate and the Canadian softwood lumber share in the U.S. market. Wear and Lee (1993), Zhang (2001, 2006), van Kooten (2002), Kinnucan and Zhang (2004), Yin and Baek (2004), Devadoss et al. (2005), and Stennes and Wilson (2005) discuss the economic impacts of the memorandum of understanding and the Softwood Lumber Agreement of 1996. Zhang and Sun (2001) focus on softwood lumber price volatility. Cashore (1998) reviews the policy and institutional differences in both countries that contribute to the longevity of the lumber dispute. Anderson and Cairns (1988), Kalt (1988), and Zhang and Laband (2005) focus on three events and the politics of the softwood lumber dispute.

This book, in contrast, attempts a comprehensive historical, political, legal, and economic analysis that weaves together these separate streams of scholarly literature, while filling in the gaps to develop a rich, compelling tapestry. Further and more importantly, it presents an interest group politics framework for solving the puzzles surrounding the softwood lumber and other trade disputes between the two countries and looks into related trade dispute settlement mechanisms that extend far beyond technical softwood lumber issues and have broad legal, economic, and political implications.

Objectives

This book addresses the politics and economics of the softwood lumber dispute by integrating the most relevant work from multiple disciplines. Using the soft-

wood lumber dispute as the primary case, along with U.S.–Canada trade disputes in newsprint, shakes and shingles, and other forest products, I illustrate and explain the political economy of forest products trade between the two countries. More specifically, the objectives of this book are as follows:

- integrate relevant works in economics, law, and political science to provide a better understanding of the softwood lumber and other forest trade conflicts between the two countries;
- place these disputes in a broader framework examining U.S.–Canada trade relations, economic developments, and the comparative advantages in resource endowments in these two countries;
- explain the longevity of the softwood lumber trade dispute;
- detail the history of the dispute and bring readers up to date on the developments that led to the Softwood Lumber Agreement of 2006;
- examine past and current trade agreements on softwood lumber, including their economic and political impacts, in both qualitative and quantitative terms, and the operation of the Softwood Lumber Agreement of 2006;
- identify potential long-term solutions to the lumber dispute as well as lessons for resource management regimes and international trade;
- provide insight on WTO and NAFTA dispute settlement mechanisms; and
- to inform a broader understanding of international trade.

In short, I intend to tell a story about the softwood lumber dispute by looking into the causes, players, processes, and outcomes as well as analyses at various stages. The story is multifaceted. At the end of the book, I suggest possible solutions based on past forest products trade conflicts, the history of the softwood lumber dispute, and the current legal and institutional frameworks in both countries. Finally, I offer some insights and inference on international trade and resource management.

Plan of the Book

The next chapter provides a literature review of the theory of economic regulation and political processes in each country, develops an analytical framework and research method, and describes historical aspects of forest resource development in the United States and Canada that sowed the seeds for the modern softwood lumber dispute. [Chapters 3](#) and [4](#) review details of the first two rounds of the softwood lumber dispute—Lumber I and II—which led to the signing of the memorandum of understanding. The economic arguments and political maneuvering on both sides of the border are documented, as are the economic impacts of the memorandum.

[Chapter 5](#) focuses on the dynamics that led to Canada's withdrawal from the MOU, a decision that ignited Lumber III. [Chapter 6](#) is devoted to Lumber III and covers the FTA process that included two binational panels and an extraor-

dinary challenge. [Chapter 7](#) documents the process and factors influencing the outcome of the 1995–1996 government-to-government consultation that ended with the Softwood Lumber Agreement of 1996. The logic and economic impact of the agreement, consumer group actions, and trade frictions during the term of the agreement are presented.

[Chapter 8](#) discusses the litigation track of Lumber IV, covering various determinations by U.S. investigating authorities and numerous rulings by NAFTA, WTO, and the U.S. courts. [Chapter 9](#) focuses on the negotiation track of Lumber IV. It documents the attempts to settle the dispute, describes the Softwood Lumber Agreement of 2006, explains who wins and who loses, and speculates on the operations of the Softwood Lumber Agreement of 2006.

[Chapter 10](#) is a comparison of the political economy of the softwood lumber dispute and the newsprint tariff battle. The last chapter explains the causes and longevity of the softwood lumber dispute from an economic, political, legal, and institutional perspective. It also presents potential long-term solutions and speculates on where the two countries go from here. Finally, it provides a summary of lessons learned from the softwood lumber dispute that may have implications for international trade and resource management.

2

Theory of Economic Policy Formation

Tariffs, tariff-rate quotas, or any other measures that are used to manage trade are forms of government regulation over economic activities. Public ownership of forest resources, private forest practice laws, and restrictions on log exports also are forms of government regulation. All of these controls have broad economic, political, and social implications. How do economic regulations arise and evolve? Do they advance the stated government objectives, such as maximizing social welfare?

Models of Policymaking

Several models of political–economic interaction in policy formation have been set forth in an effort to understand the existence and persistence of government economic regulations. Perhaps the most widely used justification for government regulations is negative externalities, which are a consequence of market failure. An externality exists when the producers of a good do not internalize the full benefits or costs of production, which means that others in society share the benefits or bear the costs. Timber harvesting, for example, may have negative impacts on water quality and wildlife habitats, but forest products companies do not count these negative impacts as part of their production costs.

Government regulations may have social and environmental objectives, such as job creation, community stability, and environmental protection, that are often used to justify intervention in forest management and forest products manufacturing. Regulators may, for example, seek to prevent mill closures, which could hurt local employment and economies, or reduce industrial pollution, which has a negative effect on the environment and human health.

Similarly, protection of domestic industry and employment is often the stated goal of restricting foreign goods and services.

Underlying effective government regulations on economic activities is the notion of government as a benevolent guardian, hampered perhaps only by innocent ignorance as it searches for best policies. In general, this public interest theory of economic regulations assumes that government decisions are based on the public interest of maximizing social welfare, public health, and social order.

A contrary view is the interest group theory, which assumes that government decisions are based on the availability of government-produced scarcity rents and the ability of legislators and government officials to maximize the value they receive for producing these rents (Stigler 1971; Peltzman 1976; Becker 1983; Zusman 1976). Rents are broadly defined to cover economic, political, or other personal gains.

Stigler (1971) and Peltzman (1976, 1984) were among the first group of economists who posit full rationality and self-interest for all policy participants, including elected officials, bureaucrats, and private individuals and firms. They argue that all policy participants use the political process to seek wealth transfers and political and economic rents. In this model, policy analysis by economists alone would serve little useful purpose, since information on the size and distribution of economic impacts caused by regulations alone would not change the behavior of any participant.

For example, after analyzing the economic inefficiency of the Interstate Commerce Commission (ICC, which regulates the trucking industry) regulations, Stigler (1971, 18) states, "The only way to get a different ICC would be to change the political support for the Commission, and reward Commissioners on the basis unrelated to their services to the carriers." In other words, if the public wants to have different regulations, change ICC: Change the incentive structure of ICC commissioners by making it independent of politics and decoupling the remuneration of commissioners from their regulatory policies.

A variant of the Stigler–Peltzman approach appears in Becker (1983), who assumes that political interest groups form in their own self-interest and that politicians rationally choose policies in response to the competing pressures these groups can exert. With competition among groups and the assumption that anything that benefits one group must either be financed directly through a tax or indirectly by costing another group (including deadweight losses), Becker (1983) concludes that resources are allocated through the political process to maximize the benefits (which are negative for the losing group) each group expects to receive.

Olson (1965, 1982) provides insights on how interest groups emerge, evolve, and function. He starts with the "logic of collective action," in which "free-rider" problems prevent the effective collusion of a large number of small losers or gainers. He then provides various hypotheses as to which pressure groups will emerge, which groups will be more effective, and the characteristics of an