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## **Contingent Protection Measures and the Management of the Softwood Lumber Trade in North America\***

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This article examines Canada's softwood lumber dispute with the United States in the context of new juridical models of international dispute settlement and an evolving trade policy environment in North America. Two questions are of central importance to this study. First, what does the rise of contingent protection measures mean for Canada's regulatory model? Strong antidumping legislation has created a new order of trade conflict at a time when intrasectoral competition has increased state support in a number of sectors. Second, how do American antidumping trade remedy measures come to bear in this dispute? In the softwood case, dispute settlement has been less effective because Canada, as the smaller economy, faces the challenge of enforcing panel decisions when the respondent has the power to avoid compliance.

Keywords: Antidumping, countervailing duties, dispute settlement, softwood, trade policy, WTO

## Introduction

Two movements have featured prominently in the recent history of the globalization of trade. The first is a limited diversification of internal markets with broad and shallow benefits for consumers. The second is an increase in intrasectoral competition accompanied by increased friction at the interface between national regulatory systems. One of the WTO's central functions is the adjudication of disputes that develop at these friction points among trade partners. For the past decade, contingent protection measures such as antidumping remedies and countervailing duties have been the preferred non-tariff barriers used by embattled domestic producers in North America. The Canada/United States softwood lumber dispute provides a timely and highly illustrative example of the evolving nature of trade remedy action under the WTO system.

This study brings together two key themes in North American trade literature, drawing critical linkages between the literature that analyzes supranational trade governance and that which examines sector-specific trade and domestic regulatory environments. Two questions are of central importance. First, what does the rise of antidumping trade protectionism mean for Canada's regulatory model?<sup>1</sup> Antidumping and countervail legislation has created a new order of trade conflict at a time when intrasectoral competition has increased state support in a number of sectors. Second, how do American dumping and subsidy measures come to bear in this dispute? Antidumping actions are difficult to counter through multilateral mechanisms because in the absence of international competition standards, trade remedies are an increasingly important feature of industrial policy. They effectively blur the distinction between national competition strategies and non-tariff protectionism.<sup>2</sup> In the softwood case, dispute settlement was not effective because Canada, as the smaller economy, faced the challenge of defending its regulatory practices against a much larger trading partner.

The first section of this article examines the use of contingent protection measures in the context of international economic relations, paying particular attention to current trade tensions around softwood lumber.<sup>3</sup> Thanks in no small part to GATT-based tariff reductions, antidumping regimes and other non-tariff trade barriers are on the rise in both developed and developing nations.<sup>4</sup> Dumping is the single largest competition issue currently facing the international trade regime, and in the first ten years of the Dispute Settlement Mechanism (DSM), antidumping and subsidies cases have been the most litigated disputes.

The second section examines Canada's softwood cases at the NAFTA and the WTO. The DSM has consistently raised the standard by which panels determine if a country has made a case for antidumping remedies.<sup>5</sup> Paradoxically, this has not led to a reduction in the number of cases brought to the WTO. Canada's trade with the United States is valued at US\$270 billion and growing (at a rate of 15 percent in 2004).<sup>6</sup> Most of it is conflict free, but softwood is a significant exception. Much to the dismay of its NAFTA partners, the U.S. Department of Commerce (DOC) has been especially aggressive in the protection of domestic industry through countervailing duties antidumping litigation.<sup>7</sup> Canada has concluded eleven legal challenges of American antidumping duties – four at the NAFTA and seven at the WTO. The key fact at the heart of this issue is that Canada and the United States regulate their forestry industries in very different ways. Despite a high degree of corporate integration in the North American forestry industry, Canada has persisted in maintaining a unique regulatory model designed to address environmental and employment issues in provinces that are economically dependent upon the forestry industry.<sup>8</sup>

The final section of the article analyzes the outcome of these panel decisions and the negotiated settlement that recently ended this round of the softwood lumber trade war. Voluntary export restraints and other bilateral mechanisms for managing, rather than liberalizing, softwood trade have been the most popular methods for managing the friction that arises from the interface between different regulatory models. Canadian policy-makers originally hoped that litigation would force a better export deal for softwood producers. They preferred a settlement in which, at the very least, the United States would lower its duties and return all of the duties collected since 2001. The American industry and its powerful lumber lobby in Congress wanted a settlement that would limit the flow of cheap Canadian lumber into the U.S. market and allow forestry companies to keep all or most of the \$5 billion in duties collected and disbursed under the Byrd Amendment. The current arrangement, much like the Softwood Lumber Agreement of 1996, is a second-best outcome to an intractable dispute. In many ways it is symptomatic of larger governance issues in the international trade regime. Canadian policy-makers are now aware that the WTO's dispute settlement architecture is not effective in bilateral disputes with the United States. They need to incorporate this knowledge into future litigation and compliance inducement strategies.

## Contingent Protection Measures and WTO Litigation

Dumping is the practice of exporting a product for less than the cost of producing it, or for less than the “normal value” of the product on the firm’s home market.<sup>9</sup> Dumping is a popular way to reduce a glut on one’s own market, and agricultural goods are sometimes treated this way. Canadian dairy producers have been taken to the WTO for this practice. Dumping is also a useful way to gain access to a foreign market dominated by other firms. Chinese goods are often hit with antidumping duties for this reason.<sup>10</sup>

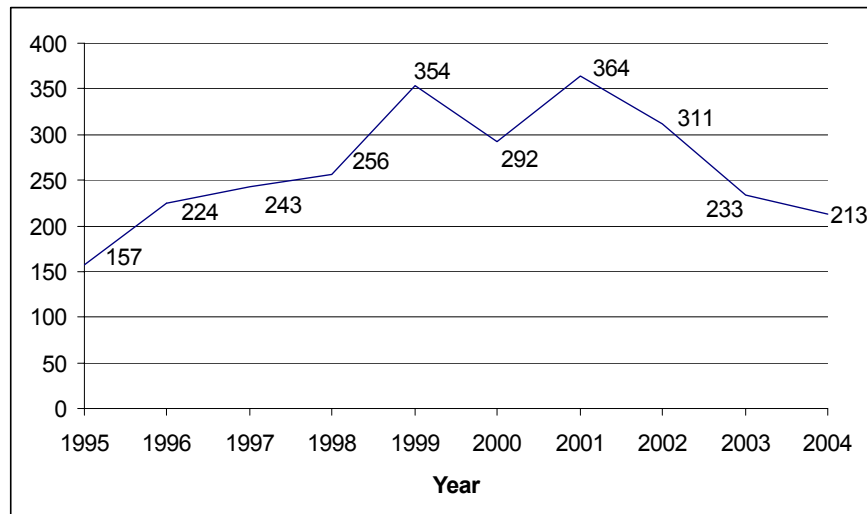
In economic terms dumping is a rational, profit-maximizing action, with little or no harm to global welfare.<sup>11</sup> In many cases, dumping goods on foreign markets can even improve consumer welfare by lowering prices. On the domestic market, producers sometimes sell their goods below cost in an effort to clear inventory or break into a market dominated by rival producers. However, in international trade, where countries have very different factor endowments, selling goods for less than the cost of production is considered by the WTO to be an unfair form of competition.

The WTO regulates the use of antidumping measures through the Agreement on Implementation of Article VI of the GATT (also known as the Antidumping Agreement, or AD) and countervailing duties through the Agreement on Subsidies and Countervailing Measures (SCM).<sup>12</sup> Article VI of the GATT provides for the right of contracting parties to apply antidumping measures. At the end of the Uruguay Round, more detailed rules for the application of such measures were spelled out in the Antidumping Agreement.<sup>13</sup> A companion to the AD, The SCM is intended to delineate acceptable forms of state support from unfair subsidy practices. The trend in dispute settlement has been towards a higher standard of proof in recent years. This attempt to dam the tide of injury actions notified to the WTO each year has not been entirely successful.<sup>14</sup> Members continue to enact AD legislation because they’ve noted its effective use by European and North American governments to protect domestic producers.<sup>15</sup>

### *Antidumping Action at the WTO*

Sixty antidumping disputes had been taken to WTO dispute settlement by the beginning of 2005, but the number of antidumping measures in place is much higher.<sup>16</sup> Figure 1 shows the trend in antidumping actions notified to the WTO. It includes both dispute settlement initiations as well as national trade remedy actions reported as per the Antidumping Agreement. Antidumping action, while formerly the domain of developed countries,<sup>17</sup> has quickly become a global issue, with Argentina, Brazil, Mexico, India, Korea and South Africa, among others, actively using this form of domestic protectionism. Actions rose sharply between 1995 and 1999, and peaked in

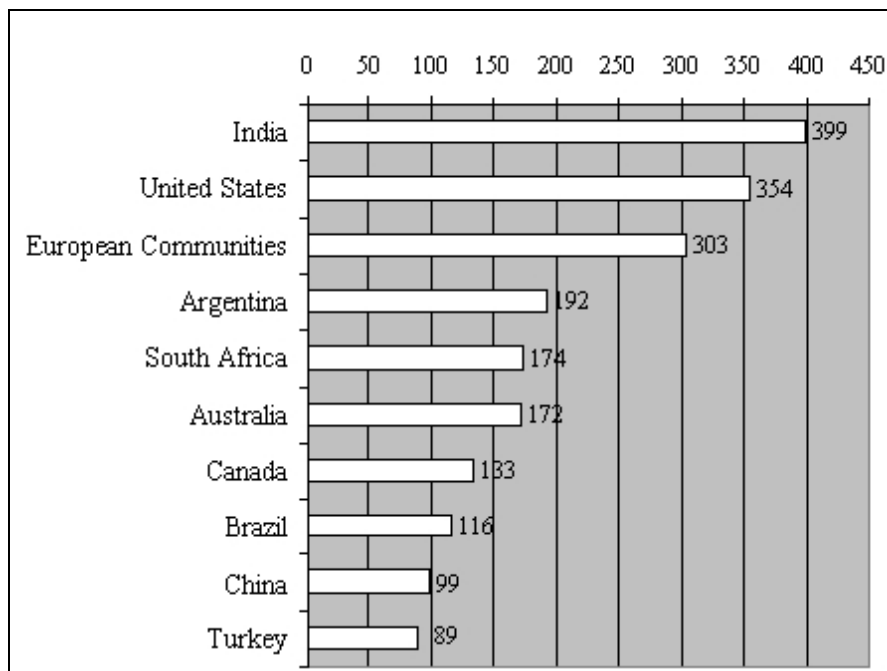
2001. Since then, reports of trade remedy action have fallen, although not to 1995 levels.



Source: WTO online antidumping databases

**Figure 1** Anti-dumping Initiations 1995-2004

The United States, in particular, uses antidumping legislation to attack a wide range of pricing practices in an attempt to enforce a more rigorous standard on the use of state support.<sup>18</sup> Many of the large developing nations who implemented the Tokyo round tariff reductions have also begun to equip themselves with antidumping legislation (see figure 2). Ruggie reminds trade watchers that the goals of trade liberalization have never been literally free trade. Rather they have been to move from the strictures of managed trade to a more liberal and multilateral governance model.<sup>19</sup> Nevertheless, it is precisely the expanding membership of the WTO that has facilitated a shift on the part of many members towards the use of ad hoc, non-tariff measures to shelter their domestic producers, because along with accession comes the right to institutionalize antidumping statutes.<sup>20</sup>



Source: WTO online antidumping databases

**Figure 2** The Top 10 Users of Anti-dumping Action at the WTO

### *Antidumping and Competition Policy*

Dumping becomes a public policy issue when jobs, growth and national competitiveness are undercut by the profit-maximizing behavior of foreign firms.<sup>21</sup> Empirical evidence supports this hypothesis. Bourgeois and Messerlin examined European antidumping cases between 1980 and 1997. They found an inverse relationship between the height of the tariff wall protecting domestic firms and the frequency of their involvement in antidumping cases.<sup>22</sup> As tariffs fell, countries engaged more frequently in antidumping trade remedy actions.

The conventional wisdom, which says that antidumping trade remedies are designed to combat the anticompetitive practices of exporters, misses the main thrust of these laws – protecting strategic industries from the predations of low-priced foreign imports. Governments rely on aggressive litigation strategies to shelter industries faced with competitive pressure to cut costs up and down the production chain.<sup>23</sup> Nevertheless, as Anderson argues, trade remedy action in the softwood context is necessarily central to the compromise of embedded liberalism because

Canada and the United States have structured their respective forest products industries in different ways.<sup>24</sup>

Canada maintains a strong state presence in the forestry industry, owning forestlands and setting the cost of cutting on these lands. The American compromise consists of generous trade remedy measures, which offset the relatively higher cost of cutting on privately owned timber reserves. National institutions shape the trade advantages of domestic firms in very different ways.<sup>25</sup> The biggest unintended outcome of the dispute settlement system has been the attempt by domestic producers and national governments to use the uncomfortable fit between national regulatory systems as a pretext for foot-dragging, preemptive litigation and other political roadblocks designed to avoid compliance.<sup>26</sup>

### **The Softwood Lumber Dispute**

**T**rade experts trace the current lumber battle with the United States back to the early 1980s, although disagreements over lumber date back as far as the 19<sup>th</sup> century.<sup>27</sup> The dispute revolves around the methods used to sell trees to timber producers. In the United States, many timber harvesters buy trees from the owners of timber lots. Harvesters hold contracts for cutting on dozens, and in the cases of the largest multinationals, thousands of lots. Sixty percent of timberland is privately owned. In the case of government-owned timberland (approximately 40 percent of timberland), harvesting rights are auctioned to the highest bidder. The cost of maintaining timber stands, and various other environmental and administrative costs, are borne by the lot owners who in turn pass them on to timber purchasers.<sup>28</sup>

In the Canadian regulatory model, the timber firm does not purchase trees from a private sector actor. Rather, they purchase the right to harvest trees from a provincial government. Stumpage fees are set by the provincial government and reflect the cost of maintaining forestland. These funds pay for some environmental and social programs, but of course the crux of the matter for U.S. timber producers is prominent provincial involvement in the industry. Stumpage fees are adjusted periodically, four times a year in British Columbia for example, and while this may reflect the up-to-the-minute value of Canadian timber, it also allows regulators to compensate for other costs in the industry. Low stumpage fees are one way provincial governments protect rural wages and jobs.<sup>29</sup> As a result, the cost of harvesting timber in Canada is lower than in the United States.

### ***Linking Subsidies to Antidumping***

The first round of the softwood lumber dispute began in 1982, and ended in a win for Canada at the U.S. Department of Commerce (DOC). The U.S. industry petitioned

against Canadian softwood lumber imports, arguing that under U.S. countervailing duty law, Canadian stumpage fees were subsidies for lumber exporters. By May of the next year, the DOC concluded that stumpage did not confer a countervailable subsidy.<sup>30</sup> In 1986 American timber lobbyists reactivated their petition for countervailing duties using a federal court case from the year before (a dispute over imports from Mexico) as a favorable precedent.<sup>31</sup> After preliminary investigation, the DOC found that Canadian stumpage fees conferred a subsidy of approximately 15 percent on producers. Canada signed a Memorandum Of Understanding (MOU) agreeing to place a 15 percent export duty on lumber shipped to the United States. The MOU remained in effect until 1991.

Canada terminated the MOU, believing that it had a solid case for the new CUFTA Chapter 19 dispute settlement mechanism. This touched off the third round of trade conflict. In one of the first countervailing duty cases under CUFTA, the panel remanded the DOC's subsidy determination three times, finding that the DOC had not made the case that provincial stumpage fees constituted an industry-specific subsidy payment. In December 1993, Canada won the final case by a narrow margin (three to two), and the U.S. Trade Representative took the case to the Extraordinary Challenge Committee (ECC), alleging a conflict of interest on the part of the two Canadian panelists. The challenge was struck down and the DOC terminated the countervailing duty order in 1994. The United States threatened to keep the duties collected, but ultimately agreed to refund them. In 1996 the Softwood Lumber Agreement was signed, restricting Canadian lumber exports for five years.

The fourth and current round of the softwood battle began on May 19, 2000, when Canada launched a judicial challenge to the current trade arrangements at the NAFTA. In April 2001, the DOC investigated timber lobby allegations that Canadian lumber is subsidized and dumped on the American market. Article 2.1 of the WTO's Antidumping Agreement states that "a product is to be considered as being dumped, i.e., introduced into the commerce of another country at less than its normal value, if the export price of the product exported from one country to another is less than the comparable price, in the ordinary course of trade, for the like product when destined for consumption in the exporting country."<sup>32</sup>

The usual test to determine dumping is a comparison of the price of the product in question on the domestic market and its price in foreign markets. The WTO's subsidy regime comes into play because firms most often make up the difference between "normal value" and export price through state support. The common assumption is most often the truth – cheap exports from developed countries are almost always heavily subsidized.



The Coalition for Fair Lumber Imports alleged that Canada's stumpage fees and log export restraints constituted a subsidy of approximately 39 percent. Along with countervailing duty investigations, the DOC conducted a nationwide investigation to determine whether Canadian timber was being dumped on the U.S. market. In an interesting twist, the Maritime provinces, where timber is harvested from private lots, were also charged with dumping. The International Trade Commission (ITC), whose job it is to determine whether American firms have been injured by dumping, found that there had been no material injury, only a threat of injury. The DOC found that Canadian timber was subsidized at a rate of approximately 19 percent, and that timber was being dumped on the U.S. market at unfair prices – with dumping margins ranging from 5.94 percent to 19.24 percent.<sup>33</sup> Since 2001, Canada has concluded eleven legal challenges – four at the NAFTA and seven at the WTO – but trade litigation has failed to deliver a judicial knockout. (See the technical annex for discussion of specific cases.)

Softwood became an antidumping issue because the American industry had made little headway in classifying stumpage fees as subsidies, and they now had a new weapon in their arsenal – the Byrd Amendment. If a case could be made that dumping was occurring, the subsequent subsidy case would be easier to make. Ironically, there is some question as to whether the Byrd Amendment could ever have applied to Canadian timber. NAFTA Article 1902 states that each party can amend or modify its antidumping laws as it sees fit, but “such amendment shall apply to goods from another Party only if the amending statute specifies that it applies to goods from that Party or from the Parties to this Agreement.”<sup>34</sup> Canada was never specified in the Byrd Amendment, but strangely, litigators never exploited this omission.<sup>35</sup>

### *What Did Canada Accomplish?*

On April 27<sup>th</sup>, 2006, Canada and the United States agreed to a truce. The United States agreed to lift the 10 percent countervailing duty on softwood imports and agreed to refund 80 percent of the \$5 billion in duties collected. Canada agreed to cap its market share at 34 percent, by collecting a sliding tax that rises as the price of lumber in the United States falls below \$355 per thousand board feet.<sup>36</sup> This deal is in place for seven years, with an option to renew for two more years. There are few substantive differences between this deal and the Softwood Lumber Agreement negotiated in 1996. The combination of export charges and volume restraints in this deal is remarkably similar to the fees charged for exceeding quantitative limits set out in the SLA.<sup>37</sup> This is the third time Canada has imposed quantitative restrictions on its lumber industry.<sup>38</sup>

The outcome of Canada's softwood litigation has been mixed. Certainly, the sweeping wins at both the NAFTA and the WTO reinforce the basic legality of the Canadian regulatory model. But the issue is not so clear-cut. The WTO panels allowed that stumpage fees are actionable under the SCM, but disagreed with U.S. methods for determining duties. Stumpage fees fall into the vast area in Article I of the Subsidies and Countervailing Measures Agreement, which delineates actionable, non-actionable and prohibited subsidies. This means that stumpage fees are not illegal under WTO law, but they can be challenged by any member who can make the case that its Most-Favored Nation benefits have been nullified or impaired by Canada's framework for regulating softwood lumber harvesting. In practice this means that even though a deal has been reached in this round of the lumber dispute, there is nothing in U.S. law or WTO law that would prevent future challenges to Canada's system of stumpage fees. This places Canada in the ambiguous position of being neither onside nor offside in the international legal environment.<sup>39</sup>

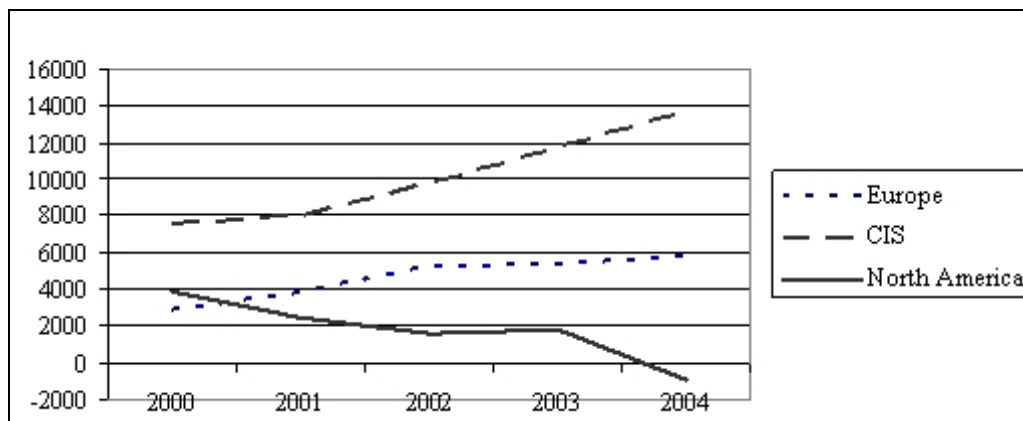
### **When National Regulatory Models Collide**

**T**he softwood lumber dispute raises significant questions asked by all trade watchers. Can the WTO reconcile its free trade mandate with the reality of a system in which states with vastly different power differentials and regulatory models use dispute settlement for protectionist ends?<sup>40</sup> Further, how does the WTO's antidiscrimination regulatory model understand the complex relationship between trade and industrial policy that takes place at the national level?<sup>41</sup> In a practical sense, the Dispute Settlement Mechanism was created in response to concerns that the GATT's dispute procedure was inadequate to the task of sorting through the complex legal issues that arise in the more deeply integrated international economy. But the new system has not proved itself up to the challenge in a number of areas, including antidumping, agriculture, textiles and services liberalization. The putative aim of the Uruguay Round signatories was to create a flexible interface between different market economies. At least in the context of contingent protection, this has not happened.

The rise of antidumping actions at the WTO has created a new order of trade conflict at a time when intrasectoral competition has increased the pressure on states to support domestic producers in a number of sectors, including agriculture, steel, textiles, wood products and high value-added manufacturing such as automobiles and aircraft. In 2005 North America experienced a net trade deficit in sawn wood for the first time ever.<sup>42</sup> Despite continuing high levels of production in North America, a massive influx of lumber from the former Soviet states is making deep inroads on this continent. The Russian Federation, Ukraine and Belarus export approximately 70

percent of their softwood production, more than 15 million cubic metres in total. Much of it goes to China, but a significant amount of cheap timber is finding its way to North America.

Trade liberalization squeezes both Canadian and American timber producers. They have responded in a fashion consistent with the compensations built into their respective regulatory models – the Americans through recourse to aggressive trade remedies, the Canadians to government intervention in the form of competitively priced stumpage fees. What to the uninformed trade watcher appears to be a simple subsidy issue is in fact the clash of regulatory models, due in large part to competitive pressure in the North American timber industry (see figure 3).



Source: UNECE 2005

**Figure 3** North America's Falling Softwood Lumber Trade Balance 2000-2004 (1,000 m<sup>3</sup>)

The current governance environment offers several challenges and possibilities for small economies engaged in complex subsidy and antidumping disputes. A singular short-term challenge remains unaddressed – that of enforcing compliance against a larger competitor. In the WTO system, dispute settlement is most likely to result in an enforceable decision when the parties are of similar economic weight and share a dense set of trade relations. Small economies are often in the position of being unable to enforce compliance – and bilateral diplomacy is increasingly critical to brokering a deal, despite the fact that it always involves a number of trade-offs between domestic producers and foreign complainants. Therefore, the DSM is unlikely in the future to

result in predictably enforceable wins for Canada vis-à-vis the United States. Canada needs to rethink its strategy for managing economic relations with the United States.

The second challenge is how to better manage the massive regulatory differences that have bedeviled the industry for decades. With a new deal in place until 2013, Canada must decide whether or not to defend its regulatory model in an increasingly integrated industry. Some experts argue that this is not possible, and long-term stability in the sector requires that Canada harmonize its policies and practices, to a greater extent, with those of the United States.<sup>43</sup> However, this simple prescription misses one of the main issues. Canada is the largest exporter of timber to the United States. Approximately 49 percent of American timber imports come from Canada. Even if Canada were to radically transform its timber industry, it still remains the largest foreign competitor in the embattled American timber sector. Regulatory harmonization is no guarantee that Canada won't feel the protectionist pressure of the American timber lobby in the future. Nevertheless, Canadian regulators need to decide if further harmonization will reduce regulatory friction, at least in the short and medium term, or if maintaining a distinctive regulatory model is more conducive to long-term stability and growth in the sector.

### **Conclusion: The Multilateral Dimension of Softwood**

**T**here are at least two possibilities for better outcomes afforded to Canada in the current governance environment. While these are not silver bullets in the current dispute, they are part of a long-term strategy for effective use of multilateral and bilateral dispute settlement processes in future trade remedy disputes with the United States. The creation of strategic alliances among like-minded states through shared negotiating positions and bilateral understandings on the use of state support would go a long way toward clarifying the issues. The Canada/Mexico relationship at the NAFTA is one example of where strategic partnership can offset the inequality built into the Canada/U.S. relationship.<sup>44</sup>

If the government is going to be heavily involved in the softwood sector, it should be done right. Proactive government intervention is required to broaden and deepen diplomatic ties and build viable partnerships, because market integration has produced an uneven set of relations – especially in the North American context. Some scholars have gone so far as to question the future relevance of the NAFTA, suggesting that the benefits accruing to Canadian business from the agreement's competitive effects have been offset by its unequal distributional effects.<sup>45</sup> American noncompliance with NAFTA and WTO panel decisions amplifies this inequity.

Also of first-rank importance is the possibility that the DSM will, in the future, provide jurisprudence that better defines best-practice guidelines for managing trade friction. The WTO may yet develop trade norms that would have a chilling effect on predatory antidumping legislation in the long term, but only if members indicate the importance of an equitable international competition policy. The WTO has gone some way in this area by raising the evidentiary standard in antidumping disputes. In other areas as well, where state support and differential pricing practices are actionable under WTO law, the growing body of panel reports may provide some guidance as to which legal, political and economic variables affect dispute settlement outcomes – which cases are winnable both in legal terms and in compliance terms, and which are best dealt with in bilateral negotiations or some other institutional forum.

Canadian policy-makers must examine these two possibilities, because the only other enforcement measure available, trade retaliation across sectors, is a political non-starter in a small, trade-dependent economy such as Canada's. Cross-sector retaliatory strategies tend to burn more good will with consumers and domestic producers than they create. However, trade litigation is not for the squeamish. A certain amount of brinkmanship is the norm in supranational dispute settlement, but the lesson that Canadian policy-makers and politicians should take from this round of softwood is that litigation in this sector is risky and seldom effective.

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The technical annex to this paper, pages 145-151 is available as a separate document.

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