ANALYTICAL REVIEW OF THE SOFTWOOD LUMBER CASE: UNDERSTANDING THE DISPUTE AND ITS CONSEQUENCES

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I. INTRODUCTION

The trade dispute between Canada and the United States regarding softwood lumber is one of the most enduring disagreements between the two trading partners to date. Beginning in the early 1980s, this issue has been debated by politicians, producers and consumers alike. The implementation of American protectionist measures against Canadian lumber exports has led to many adverse effects for both countries, including lost in Canadian market share within the sector, increasing prices for American consumers, etc. Canadian producers have lost market share over the past few years as a result of the pre-existing conditions. Though the goal of free trade is essentially the driving force behind federal economic policy, each country will work toward its own best interest to maximize profit. The Softwood Lumber Agreement of 2006 attempts to remedy the frigid trade relations, yet many believe that Canadian producers are still in a disadvantage. This paper will attempt to outline and explain the dispute, as well as describe the effects for producers and consumers.

II. IMPORT BARRIERS

Softwood lumber encompasses all "easy-to-saw wood such as pine and spruce… [which is typically] used in building… [or construction],"[1] and is measured in board feet. One board foot is equal to 144 cubic inches, or one square foot of one-inch thick board. American protectionism or trade remedy actions, toward imports of softwood lumber from Canada initially began 20 years ago. Protectionism is considered the safeguarding of one country's domestic industry against foreign competition.[2] Barriers to free trade, or protectionist actions, may take the form of tariffs, non-

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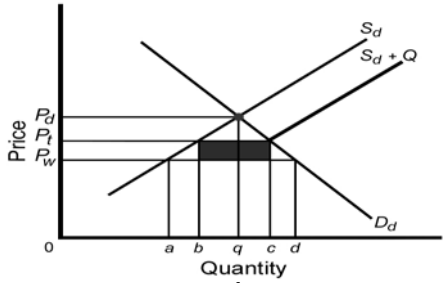
[1] "Indepth: Softwood lumber dispute," accessed 2 Oct 2006.

[2] Michael Parkin and Robin Bade, Microeconomics: Canada in the Global Environment, 3rd Ed. Ontario: Addison-Wesley Publishers Limited, 1997, 912.

tariff barriers usually known as quotas, or trade remedy measures which can be divided into two broad groups, as antidumping duties (ADs) or countervailing duties (CVDs).[3]

A primary example of a barrier to free trade is a tariff; essentially a tax placed upon imported goods by the government of the importing country.[4] In effect, tariffs increase the price that consumers must pay for the good, while at the same time motivating increasing domestic production and generating revenue for the government of the importing country.[5] Another barrier is a quota, which refers to the "quantitative restriction… [that] specifies the maximum amount of the good that may be imported in a given period of time."[6]

Figure 1: The Economic Effects of a Protective Tariff or an Import Quota



Source: Macroeconomics, 10th Canadian Edition, page 393.

Figure 1 represents the economic effects of either a tariff of quota imposed by the American government on Canadian softwood lumber. The shaded area *PwPt* represents the tariff, which is paid by American consumers when they buy lumber sector goods. Domestic consumption will be reduced from *d* to *c* as a result of this tariff and the price of wood products is raised by the amount of the imposed tariff. This reduction in consumption also means that domestic producers are able to "sell more output (*b* rather than *a*) at a higher price (*Pt* rather than *Pw*)."[7] Canadian exporters are then hurt because they are only able to sell the quantity *b-c* rather than their previous level of *a-d* in the American market, thereby reducing the market share of Canadian producers.

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[3] *Ibid*, 3.
[4] Michael Parkin and Robin Bade, Microeconomics: Canada in the Global Environment, 3rd Ed. Ontario: Addison-Wesley Publishers Limited, 1997, 912.
[5] *Ibid*, 914.
[6] *Ibid*, 916.
[7] C. McConnell, S. Brue, T. Barbiero, Macroeconomics, 10th Canadian Ed. (Canada: McGraw-Hill Ryerson Limited), 2005, 393.

> "An import quota of *bc* units will have the same effects as the tariff, with one exception: the shaded area will go to foreign producers rather than the American government."[8]

Therefore, the introduction of a quota or tariff in the softwood imports by the U.S. hurts Canadian lumber producers more than the American consumers.

The other two kinds of barriers are particularly important to the issue of Canadian softwood lumber. Antidumping duties are tariffs meant to avoid dumping by foreign countries, whereas countervailing duties are tariffs that are implemented to offset the subsidies by foreign countries.[9] Dumping refers to the act of foreign firms "[selling] exports at a price below [their] cost of production"[10] and may be used to gain a monopoly over the market by putting domestic firms out of business.[11] Dumping is one of two issues at the very heart of the softwood lumber dispute.

II. HISTORY OF THE CONFLICT

The conflict over softwood lumber began in 1982;

> "when an alliance of U.S. lumber companies called the Coalition for Fair Lumber Imports (CFLI) alleged that Canadian companies enjoyed subsidies in terms of [the] extremely low stumpage rates [that] they [were paying] to log on Canada's Crown Lands."[12]

Canada was also accused of dumping its product into the U.S. market, thereby "[driving] down the prices of U.S. producers, putting many out of business."[13]

Under the 1973-79 Tokyo Round of the General Agreement on Tariffs and Trade, the Subsidies and Countervailing Duties Code (SCDC) identified a domestic subsidy as "the outright payment of a dollar amount

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[8] *Ibid*, 393.
[9] Michael Parkin and Robin Bade, Microeconomics: Canada in the Global Environment, 3rd Ed. Ontario: Addison-Wesley Publishers Limited, 1997, 918.
[10] *Ibid*, 919.
[11] Michael Parkin and Robin Bade, Microeconomics: Canada in the Global Environment, 3rd Ed. Ontario: Addison-Wesley Publishers Limited, 1997, 918.
[12] Peter Berek, "Contested Trade in Logs and Lumber," in International Agricultural Trade Disputes: case studies in North America, ed. Andrew Schmitz, Charles B. Moss, Troy G. Schmitz and Won W. Koo, Calgary: University of Calgary Press, 2005, 122.
[13] Paul Wonnacott, "The United States and Canada: The Quest for Free Trade: an examination of selected issues," Institute for International Economics: policy analysis in international economics, 16 (1987): 91.

per unit of output, or the provision of loans at less than market rates as an incentive to initiate or expand production."[14] Under Article 9 of the SCDC, subsidies to domestic industries are only allowed in special circumstances, such as to farmers during a long and harmful drought. However, if they are found to be damaging to the domestic industry of another country, then the injured party may impose a countervailing duty to offset the effects.[15] Under this framework, the American producers claimed injury through alleged subsidies and dumping actions by the Canadian suppliers. A large part of this argument stemmed from the fact that, "between 1975 and 1985, Canadian softwood lumber production increased 105%, while U.S. softwood lumber production rose only 19%."[16]

Throughout the next two decades, numerous antidumping and countervailing duties, as well as export fees, were imposed on lumber exports from Canada. In recent years, the U.S. protectionist sentiment and resistance to free trade has increased, in big part, due to the "migration of selected jobs out of the country," as well as job loss in domestic terms.[17] According to some arguments, the U.S. employment-population ratio (Figure 2) indicates that, "free trade has not resulted in [the] massive job loss… as some protectionists claim."[18] As a whole that may be true, but upon examination of sector and job specific charts, a slow decline in employment is apparent. This occurrence is doubtfully the result of free trade, and in this case, most likely a reason for protectionist measures by the U.S. These measures, tariffs and non-tariff barriers, not only harm Canadian producers, but also drive up the cost of consumer wood products to American consumers.

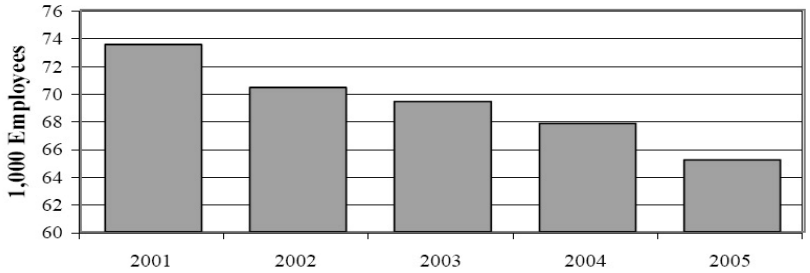
The U.S. Employment-Population Ratio graph is a good place to start when looking at employment trends, but it does not provide with sector specific information. When viewing these graphs, it is important to remember that the Employment-Population Ratio graph examines total labour trends over a period of over twenty years, while the Wood Industry graphs examine 2001-2005 sector and job specific employment trends relevant to this paper.

[14] *Ibid*, 90.
[15] *Ibid*, 90.
[16] Paul Wonnacott, "The United States and Canada: The Quest for Free Trade: an examination of selected issues," Institute for International Economics: policy analysis in international economics, 16 (1987): 92.
[17] "B.C. Stats Exports: February 2005," accessed 6 Nov 2006.
[18] *Ibid.*

Figure 2: U.S. Employment – Population Ratio (%)

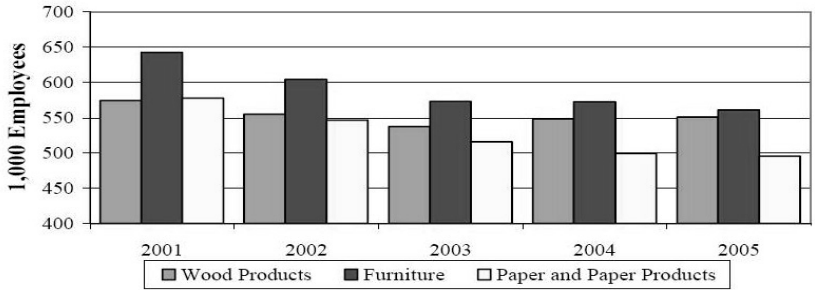
Source: U.S. Department of Labor, "B.C. Stats Exports: February 2005," page 3.

Figure 3: U.S. Logging Employment



Source: U.S. Bureau of Labor Statistics, "Key Wood Industry Graphs," page 5.

Figure 4: U.S. Manufacturing Employment



Source: U.S. Bureau of Labor Statistics, "Key Wood Industry Graphs," page 5.

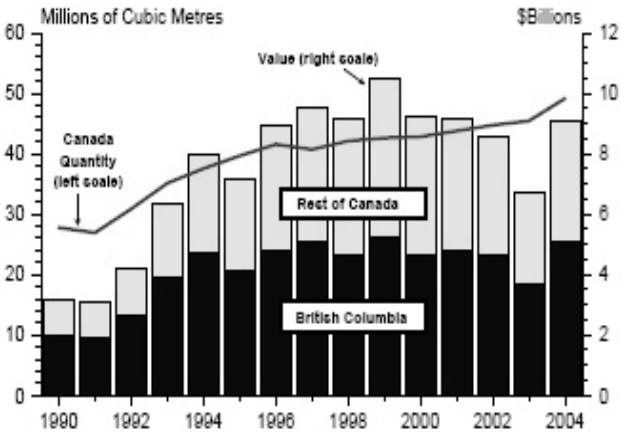
Evidently, while the overall employment of the U.S. population remains relatively stable, the logging sector has shown small, yet relatively steady decrease over time.

The migration of selected jobs out of the country has driven much of the protectionist sentiment in the U.S.,[19] and as a result of the sector-specific job loss, the United States responded by applying protective measures to the lumber industry to protect its own domestic interests. In 2002, the U.S. applied a tariff of 27% on Canadian softwood lumber imports, which generated approximately $5.3 billion for the U.S. government through tariff revenue.[20] This tariff also cost Canadians thousands of lost jobs, causing small Canadian communities to suffer, as mills shut down in order to streamline business and generate profit.[21]

IV. THE SURVIVAL OF THE INDUSTRY

It is remarkable, that despite the protectionist measures imposed by the U.S. causing the closure of a number of mills, the Canadian volume of lumber exports to U.S. continues to climb.

Figure 5: Lumber Exports to the U.S. from Canada



Source: Statistics Canada, "B.C. Stats Exports: Feb 2005," page 5.

Central to the issue of softwood lumber is the importance of imports and exports to both the United States and Canadian economy. Over time, Canadian exports have risen as a percentage of the Gross National Product

[19] "B.C. Stats Exports: February 2005," accessed 6 Nov 2006, page 3.
[20] "Softwood deal survives vote in House of Commons," accessed 30 Sept 2006.
[21] "A mill town struggles to survive," accessed 28 Sept 2006.

(GNP),[22] which is defined as "the total income that residents of a country earn within the year."[23] These exports have increasingly been directed toward the United States, clearly showing the "[increased] dependence of Canada on the U.S. market."[24]

> Although the United States is the largest producer of forest products in the world, it is a net exporter. The domestic production of softwood lumber accounts for only about 60% of U.S. consumption and the rest is met with imports… [while] approximately 80% of [Canadian] forest-product exports find their home in the United States.[25]

During the 1990s, Canadian lumber exports continued in an upward trend from approximately 15 million cubic meters in 1990 to over 50 million cubic meters in 1999, generating respectively $4 and $11 billions CND (Figure 2). The effect of the softwood lumber dispute become apparent in the period between 1999 and 2003, when lumber exports to the U.S. dropped to a low of approximately 31 million cubic meters, the same overall output of 1993.

In terms of lumber, if Canada is indeed a large producer and the U.S. is a large consumer, it would be feasible to say that both countries could expect to exercise great market power.[26] Yet upon closer examination it is clear that it is Canadian producers who have lost market share, and therefore market power, within the lumber sector. This loss is predominantly evidenced by mill closures across Canada. It is estimated that in the last 1.5 years, "11,400 [B.C.] sawmill workers and machine operators have lost their jobs in 46 mostly remote, often single industry, towns."[27] Approximately 70% of B.C.'s total harvested softwood lumber is sold to the U.S. and more than "125,000 [provincial] workers depend on

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[22] Paul Wonnicott, "The United States and Canada: The Quest for Free Trade: an examination of selected issues," Institute for International Economics: policy analysis in international economics, 16 (1987): 59.
[23] C. McConnell, S. Brue, T. Barbiero. Macroeconomics, 10th Canadian Ed. (Canada: McGraw-Hill Ryerson Limited, 2005, 113.
[24] Paul Wonnicott, "The United States and Canada: The Quest for Free Trade: an examination of selected issues," Institute for International Economics: policy analysis in international economics, 16 (1987): 59.
[25] Janaki R.R. Alavalapati and Shiv Mehrotra," in Political Economy of the Canada-U.S. Softwood Lumber Trade Dispute," in International Agricultural Trade Disputes: case studies in North America, ed. Andrew Schmitz, Charles B. Moss, Troy G. Schmitz and Won W. Koo (Calgary: University of Calgary Press, 2005), 139.
[26] *Ibi*d, 139.
[27] "Clear-cutting the Lumber Business," accessed 3 Nov. 2006.

the forest industry for employment."[28] American protectionism has often hit British Columbia the hardest, as this province is the largest exporter, followed closely by Quebec and Ontario, as shown in the Appendix.

As past years have shown, the split between harvesting locations has the ability to affect Canadian market share in the softwood lumber sector. Under the first Canada-U.S. Softwood Lumber Agreement in effect from 1996-2001, any province or firm that harvested on private land was exempt from extra U.S. duties.[29] Their market share increased, while those that forested on crown land (B.C., Quebec, Ontario, etc.) saw their market share decline.[30] This loss is then an indicator of an increase in market competition. Also, since the provinces hardest hit by U.S. duties were the greatest lumber exporters, if the foreign market access were to remain constant, then we could assume that a greater number of firms will be competing for the same market.

On a global economic scale, the competitiveness of Canadian firms is being increasingly challenged by the emergence of new, low-cost regions. Fast-growing tree farms in Chile and expansion into unexploited forests in Russia are pushing down global prices and reconfiguring traditional trade flows.[31]

According to forestry experts, this loss of competitiveness is also because

> "… public ownership of Canada's timberlands… [has subjected Canadian companies]… to an outdated and onerous tenure system that has at once bred complacency and handcuffed their ability to compete."[32]

As a result, because Canadian firms do not own the land on which they operate, they have no incentive to plant more trees than they have to or invest in new technologies."[33] Consequentially, they produce "commodity goods like sawed lumber, pulp and newsprint instead of high-end consumer products like tissue paper."[34]

Inefficiency within the Canadian industry is another dynamic that plays into the loss of competitiveness and market share. The lumber sector in Canada is full of small, old, costly and unproductive mills that "doesn't

[28] "Feeling the Pain," accessed 3 Nov. 2006.
[29] "Indepth: Softwood lumber dispute," accessed 2 Oct. 2006.
[30] *Ibid.*
[31] "Clear-cutting the Lumber Business," accessed 3 Nov. 2006.
[32] "Clear-cutting the Lumber Business," accessed 3 Nov. 2006.
[33] *Ibid.*
[34] *Ibid.*

boast a single company among the world's top 20, despite access to vast timberlands."[35] One possible solution is the merger of smaller mills. Modeling this proposed solution are a few local B.C. companies. Following the 2002 U.S. imposition of a 27% duty on Canadian lumber, these mills converged and were making record profits despite the lack of any concrete lumber agreement at the time.[36]

The issue of free trade versus protectionism is another key point in the softwood lumber dispute with various implications. Many economists hold that free trade raises productivity, wages, and consumer welfare by forcing countries to specialize in the narrower range of goods for which they have a cost advantage… [yet]… industrial restructuring [means that workers are laid-off and]… must leave high-cost, import competing industries in search of new jobs.[37] Still, the gains from free trade seem to outweigh the negative effects of free trade when compared to protectionist measures previously discussed.

Ideally, all governments wish to increase employment so as to boost productivity and ultimately generate national revenue. On a smaller scale, individual firms wish to reach economies of scale, where the average total cost of production decreases "as the firm expands… [its output] in the long run."[38] Therefore, if total cost is equal to variable cost plus fixed cost, then to increase profits, the total unit cost of production (the variable cost per unit plus the fixed cost of production per unit), must be reduced.

Free trade between nations is beneficial, in the sense that it is based on the principle of comparative advantage, which "allows countries to specialize in areas where they have an advantage due to… resource availability or abundance of labor."[39] Therefore production efficiency increases while production costs decreases. In turn, this "reduces the cost of inputs for other industries and makes consumer goods less expensive."[40] Consumers are left with a higher level of disposable income while demand for less expensive goods increases, which then creates more jobs. In this specific case, protectionist policies

> "subvert the positive effects of free trade by propping up inefficient industries and driving up prices. [They] may help

[35] *Ibid.*
[36] *Ibid.*
[37] Daniel Trefler, "No Pain, No Gain: Lessons from the Canada-U.S. Free-Trade Agreement," in Incomes and Productivity in North America: paper of the 1997 seminar, (Dallas: Bernan Press and the Commission for Labor Cooperation, 1997), 25.
[38] C. McConnell, S. Brue, T. Barbiero. Macroeconomics, 10th Canadian Ed. (Canada: McGraw-Hill Ryerson Limited, 2005, 436.
[39] "B.C. Stats Exports: February 2005," accessed 6 Nov 2006.
[40] *Ibid.*

> small groups of producers, but [they] almost always [result] in higher prices for consumers and often [have] negative effects on other industries." [41]

In this context, if the duties and quotas against Canadian lumber exports were eliminated, Canadian producers would see greater profits, and the cost to American consumers would decrease.

V. THE NEW AGREEMENT

Under the new Softwood Lumber Agreement signed in early 2006, approximately 80% of the $5.3 billion handed over in duties on lumber since 2001 would be returned to Canadians. In addition, Canada will be allowed to keep, but not expand, its current 34% of U.S. market share.[42] The last point of interest is the export tax that the Canadian government will collect from Canadian producers, if the price of lumber falls below $355 per thousand board feet.[43] Many critics of this new bi-lateral settlement feel that Canadian producers are, yet again, on the losing end of trade negotiations with the United States. This agreement points directly to the fact that each country will indeed, work toward its own national interest to turn a profit. Essentially, all of these factors indicate that the movement toward freer trade between Canada and the United States is showing some progress, yet still has a long way to go.

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[41] *Ibid.*
[42] "Indepth: Softwood lumber dispute," accessed 2 Oct. 2006.
[43] *Ibid.*

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Graphs

"B.C. Stats: February 2005", Ministry of Management Services, The Government of British Columbia, Last updated: April 2005. <http://www.bcstats.gov.bc.ca/pubs/exp/exp0502.pdf> accessed 31 Oct. 2006

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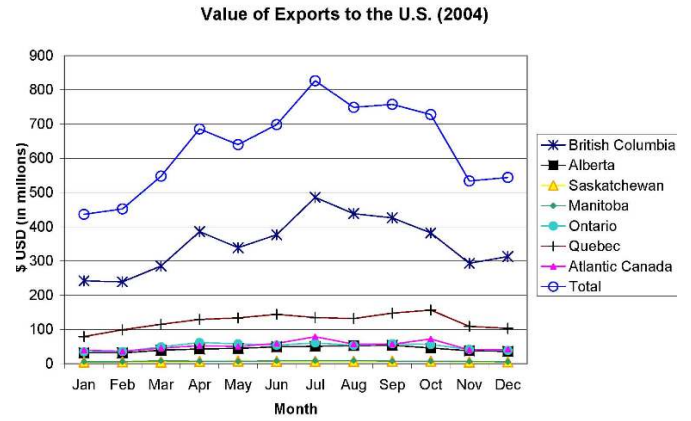
APPENDIX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$ USD (in millions)
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British Columbia
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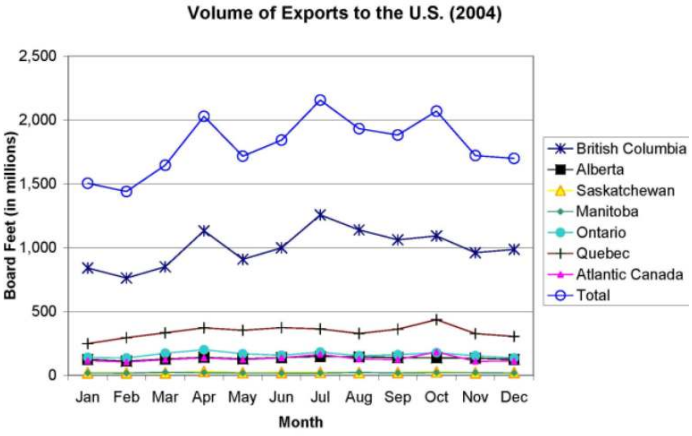
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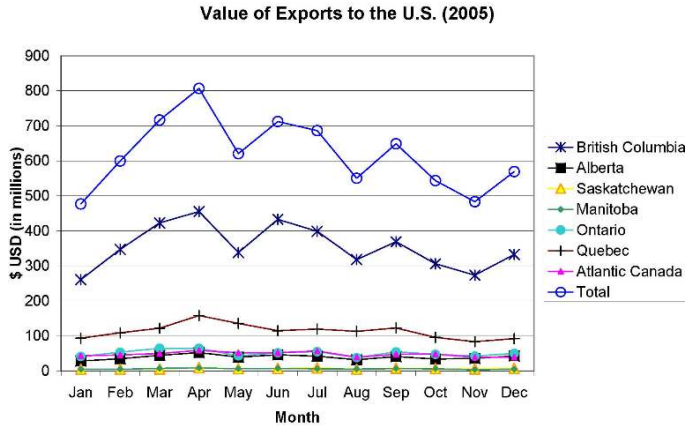
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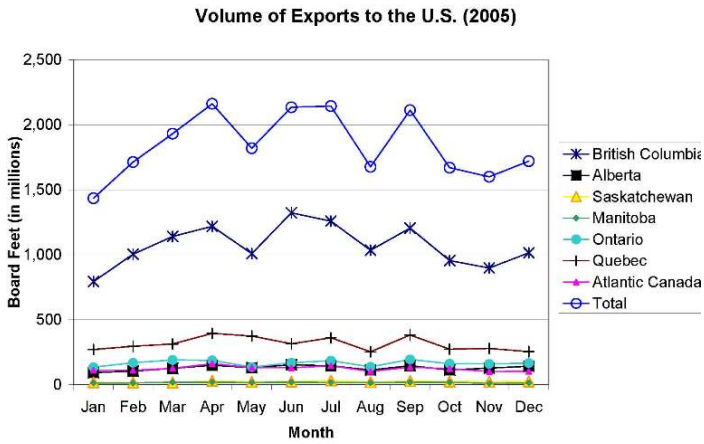
Volume of Exports to the U.S. (2005)
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Alberta
Saskatchewan
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Atlantic Canada
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