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Administering the Softwood Lumber Agreement: The Case for Tax-Only Export Measures

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The draft softwood lumber agreement reached with the United States on April 27, 2006 makes the best of a bad situation and buys lumber producers an interlude of much-needed peace free from the punishing effects of US trade actions. The tough decisions for Canadian policy makers will not end when negotiations with the Americans conclude, however. Assuming a final agreement can be reached, Canadian governments will need to administer it in a way that balances the objectives of fairness and industry competitiveness against the desire of producers to be compensated for losses they incurred in the latest lumber battle. An essential issue will be to decide on measures to limit exports to the United States. Based on experience with similar trade situations, notably allocations of import quotas for supply-managed commodities like cheese, eggs and poultry, Canada might have only one opportunity to get this right. This argues for careful planning and some political backbone in the early stages to avoid problems later on.

Export access to the United States is a valuable prize. The trade restrictions will likely increase prices in the American market relative to those in Canada. When the antidumping and countervailing duty findings were in place, much of this extra profit — or economic rent — was captured by the US Treasury in the form of duties. With removal of the duties, the rent is now available to be divided among Canadian producers and governments. The question is: on what basis should they share export access to the United States, and the benefits that accompany it?

The Framework Agreement reached with the United States provides for either a sliding export tax or a combination of a smaller export tax and quantity limitations applied to exports when lumber prices fall below US$355 per thousand board feet (MBF). Table 1, below, shows the two options available at different price levels:

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Table 1: *Export Measures Available under the Softwood Lumber Framework Agreement*

Price Per Thousand Board Feet (MBF)	Option A: Export Charge Only (%)	Option B: Export Charge Plus Volume Restraint[a]
Over US$355	0	0
US$336-355	5	2.5% + regional share of 34% of US consumption
US$316-335	10	3% + regional share of 32% of US consumption
US$315 or under	15	5% + regional share of 30% of US consumption

Source: Basic Terms of a Canada-United States Agreement on Softwood Lumber http://www.dfait-maeci.gc.ca/eicb/softwood/basic-terms-en.asp

[a] A region's market share is based on its average share of Canadian exports to the United States over the 2001-2005 period, applied to the overall Canadian share of the US market. The BC interior, BC Coast, Alberta, Saskatchewan, Manitoba, Ontario, Quebec and Atlantic Canada are considered regions for the purposes of the Agreement, although the latter is generally excluded from export restrictions.

It is worth noting that the current market prices for lumber are generally above the US$355/MBF trigger price. The provisions of the Framework Agreement would only impinge on the free market result if prices fall.[1] A downturn in the currently hot US housing market would almost certainly lead to weaker demand, lower prices and, consequently, the need to impose export restrictions.[2]

While responsibility for administering the export measures lies with the Minister for International Trade, the federal government will consult with provinces on which of the two options to apply to exports from each region. Indications are that all provinces except British Columbia favour Option B, the combination tax plus volume-restraint alternative. While provinces will have to make their choice on implementation of the Agreement, it is possible that the Agreement will provide them with an opportunity to change their minds.

Option A is the better alternative. The tax-only option would capture a greater share of the economic rents for the benefit of all taxpayers. More importantly, it avoids the need to impose quantitative export restraints. A tax-based system is responsive to market realities since it ensures that those producers who most want to export, and who are presumably the most cost competitive, participate in the market. It ensures that business — and not governments being

1 On May 19, 2006, the price for Random Lengths Framing Composite lumber fell to US$345/ MBF. The duration of the trigger period and whether the quota comes off after a certain period has not yet been determined. The trigger period will likely be based on a moving average of monthly or quarterly prices.

2 There are predictions of a decline in North American consumption in 2006 and 2007. According to one analyst, lumber prices in 2007 will average US$325/MBF. See RBC Capital Markets (April 4, 2006) *Paper and Forest Products: 2006 and 2007 Sector Outlook*, p. 17.

lobbied by business — decides who exports and who does not. This would lead to a more efficient outcome for the industry.[3]

Lumber producers will likely favour Option B, the combined tax and volume-restraint method, since it provides for lower taxes and assures current exporters stable access to the US market. However, Option B imposes an overall volume restraint and would require a system for allocating the limited export volume among regional producers. The most likely method of choosing between exporters would be to allocate quota on the basis of historic export performance.[4]

It was partly because of the infighting among producers and provinces over quota allocations that Canada abandoned the 1996 Softwood Lumber Agreement with the United States.[5] The case for quota allocations based on historic export performance is even weaker now than it was in 1996. Gone is the pretence that changes to Canadian timber management practices are the rationale behind the US industry's trade actions.[6] It is quite possible that "managed trade" will survive even beyond the seven-to-nine- year life of this agreement and could become a permanent feature of the North American lumber market.[7] Governments might want to think carefully about embarking on an administratively challenging system that makes historic performance the basis for long term entitlement. Quota systems rarely start off as permanent but often end up that way.

One only has to examine the Canadian cheese import business to understand the pitfalls of quota allocations. An import quota for cheese was first allocated in 1975 to a small group of historic importers. In 1991, the average economic rent to import-quota holders was estimated to be as high as $2.43 per kilogram.[8] In the view of cheese importers, the quota confers a legal right of permanent entitlement, something quota holders have not hesitated to defend in

3 For a thorough discussion of the advantages of an export tax over other methods for limiting exports, see R.J. Wonnacott (April 2006) "The Softwood Lumber Dispute: A Proposal" RBC Financial Group Economic Policy Research Institute, EPRI Working Paper Series, University of Western Ontario.

4 Other criteria could be used to allocate export quotas, such as share of provincial production or employment. Export quotas could also be set aside for new entrants to the industry, aboriginal producers or other groups considered worthy. The more complex a quota allocation scheme, however, the more administratively onerous it is and the more susceptible it is to rent-seeking behaviour.

5 As a result of the 1996 Softwood Lumber Agreement, quota was allocated to Canadian producers on the basis of historical export share and provision was made for new entrants to the industry. Canada walked away from the 1996 Agreement after five years, arguing that changes to provincial stumpage programs removed the basis for the American duties. Within a week, the US industry launched the current round of antidumping and countervailing duty actions.

6 Testimony of Carl Grenier (February 22, 2005) to Subcommittee on International Trade, Trade Disputes and Investment of the Standing Committee on Foreign Affairs and International Trade.

7 In testimony before the House of Commons Trade Committee, International Trade Minister David Emerson predicted that he would be "dead and buried" before free trade in lumber is ever achieved. "Not Free Trade, But Not Bad, Says Emerson" (May 16, 2006) *The Globe and Mail*, p. A6A.

8 The economic rent estimate is the price quota holders charged simply to transfer quota temporarily to another exporter. (Canadian International Trade Tribunal (1991)). It is quite likely that in the 15 years since the CITT prepared this estimate, import quota values have increased even further. Cheese imports have remained fixed at 20.4 million kgs per year since 1978. Imports as a percentage of the Canadian market have fallen, increasing the scarcity premium attached to quota holdings.

the courts. Despite reform attempts over the years, the system remains largely unchanged and continues to provide a generous windfall to a select few.

Canadian lumber producers have suffered greatly in recent trade battles with the United States. It is understandable that they would view a guaranteed share of the restricted export volume as part of the spoils of war and pressure governments to adopt a combined tax and volume-restraint option for administering the agreement. However, industry needs to emerge from the seven-to-nine-year life of the Agreement well positioned competitively to take on the financial and trade challenges that it will inevitably face.[9] One way to help accomplish this is to avoid entrenching a sense of entitlement that could lead to rent-seeking behaviour and industry in-fighting. As federal and provincial officials consider which option to select, they should keep in mind that the longer term interests of the industry are best served by a tax-only export measure that provides all producers open and flexible access to the US market during the life of the current Agreement.

9 Among the challenges facing the industry in the coming years is the prospect of lower U.S. housing starts, which will mean slow demand and weak lumber prices. See "The Odds May Be Stacked Against You" (May 1, 2006) *The Financial Post* and The Conference Board of Canada (Spring 2006) *Canadian Industrial Outlook: Canada's Wood Manufacturing Industry*.

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