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INTRODUCTION

After more than 2 decades of trade dispute, the softwood lumber impasse is still unresolved. While hope has recently been expressed for an agreement soon, it is very important that this be a long-term rather than a temporary solution. The stakes are high. In a trade war, like any other, both sides can expect to lose. For Canada, there has been the well-understood economic costs of facing U.S. restrictions on its exports, and the sense of failure that sporadically weakens public support of NAFTA and leads to calls for retaliation that could spread the dispute to other sectors. For the U.S. seeking to take the initiative in broader liberalization, there is the diplomatic cost of waging an apparently unending legal war with a free trade partner. Moreover, U.S. protection is costly not just for Canada, but for the U.S. as well, not only because U.S. lumber buyers face too high a price, but also because of the reduced pressure from Canada on U.S. producers to innovate and reorganize in the face of increased competition from third-countries.

CANADA'S OPTIONS

Renegotiate NAFTA's Dispute Settlement. While we should sound out the U.S. on whether we could now agree on making NAFTA's present dispute settlement mechanism work better, it would be a mistake, in my view, to open any formal renegotiation of NAFTA - - or even just its dispute settlement - - that would require the approval of the U.S. Congress; the risk is

that, given the protectionist influences there, NAFTA would be weakened rather than strengthened. An intermediate possibility might be to improve NAFTA's dispute settlement in an agreement not requiring congressional approval. (Though easier to make, it would be easier to break).

Retaliation. It would be dangerous to risk triggering a trade war. In 'small' industries where Canada has little influence over international price, any round of retaliation would make Canada the big loser. While both countries would suffer efficiency losses from market-distorting protection, these losses for Canada would be augmented by an income transfer from Canada to the U.S.[1]

On the other hand, in 'large' industries (e.g. oil, natural gas) where Canada as well as the U.S. does influence international price, transfers from a round of retaliation would be unclear; but because of efficiency losses from restricted trade, both countries would collectively lose, as probably would each. Moreover, the interprovincial conflicts resulting from a Canadian restriction on an important export such as oil would be sufficient to disqualify such a policy. To minimize the risk of triggering a trade war, Canada would be unwise to retaliate by a restriction on either imports or exports that would substantially damage the U.S.

In short, any trade restriction would either significantly hurt the U.S. or it would not. If it did, we would risk retaliation, possibly leading to a trade war. If it did not, what's the point, aside from the political cosmetics?

[1] With prices in any Canadian 'small' industry essentially determined in the large U.S. market, a Canadian tariff tends to raise price in Canada and thus transfer income *domestically* within Canada, from Canadian buyers to the Canadian treasury that collects the duty. In contrast, a U.S. tariff tends to transfer income *internationally* from Canada to the U.S.: specifically, it lowers the price received by a Canadian exporter - - who , in selling in, say, Chicago, gets only the U.S.-determined price and thus, directly or indirectly, has to absorb any U.S. tariff. Accordingly, a U.S. tariff transfers income from Canadian exporters and indirectly their labour force, to the U.S. treasury that collects the tariff revenue. Therefore, the only international transfer from such a round of retaliation is from Canada to the U.S.

Continued Legal Action. 'Litigating to the end' has a wide appeal to Canadians (and especially those who originally negotiated NAFTA) who were justifiably offended last August by the U.S. disregard of a judgment by a NAFTA Extraordinary Challenge Committee that the U.S. itself had insisted be included late in the NAFTA negotiations. But relying solely on continued legal action would be costly (though less so relative to the stakes than frequently perceived) and there's no assurance that it would be completely successful: past judgments in NAFTA and the WTO (GATT) have often favoured Canada, but not always.

Rather than speculating on the probability of an eventual legal success, suppose the result turned out to be 100% in our favour. Even this would not guarantee a long-term solution, since it would leave us facing the future risk of new U.S. action, and further extended legal dispute. A long-term solution requires dealing with the underlying sources of this conflict in an agreement that both countries can live with. Without this, the U.S. could, for example, make a new injury claim which would be far more likely than at present to be sustainable in a recession, or even before. In short, litigation can play an important role now in pressuring the U.S. and improving our bargaining position, but it alone cannot be expected to provide a long-term solution.

Negotiation. In some special circumstances (like mad cow?) there is a conflict that cannot be resolved solely by legal process in a trade treaty. This seems to have become increasingly true of softwood lumber because, during a festering dispute since the early 1980s that predates NAFTA, conflicting interests have become financially and politically so well entrenched. Thus a long-term solution requires a negotiation, with continued Canadian litigation pressure in a supporting role. Any success on this legal front will not only add to Canadian negotiating strength but will also increase the U.S. incentive to view bargaining as superior to a status quo that is both under legal attack and causing diplomatic damage. It may also help to

cement an agreement by establishing precedents to restrict U.S. elbow room in taking any future action against Canada.

While there is no way of knowing precisely where a negotiation may lead, the following 'target package' illustrates how beneficial a negotiated agreement could be for Canada.

A PROPOSAL FOR NEGOTIATION

The U.S. would agree to:

A. ***Removal of the U.S. tariff*** Effective last December 12, the U.S. tariff was revised downward to an average of 10.8% from 20%.

B. ***Substantial return of past duty revenue*** collected by the U.S. government.

While these would satisfy Canada's objectives, what might the U.S. expect from Canada in return?

C. ***A change in stumpage policy*** and an end to restrictions on log exports. While it isn't evident whether or to what degree the U.S. government may now be backing off its earlier insistence on these changes, U.S. producers in the Northwest are still holding to this demand. Therefore it isn't entirely clear to what degree a change in these policies would be an accommodation necessary to reach an agreement now, and/or an important insurance against future U.S. claims against Canada.

D. ***Some continued protection of its softwood lumber industry*** Suppose that, in agreeing to go most of the way in removing the current 10.8% protection of its industry, the U.S. refuses to give it all up. (No matter how much the U.S. softwood lumber industry may emphasize its philosophical desire for free markets, it seems clear that, at least in part, its objective is good old-fashioned protection.) Instead of

allowing such a U.S. demand to break the deal, why shouldn't we (after strongly resisting and thereby extracting maximum concessions from the U.S. in other areas) comply, provided we get to administer this protection in a way that will *further* benefit Canada and be acceptable to the U.S., an example would be a Canadian x% export tax.

Note that so long as the x% Canadian export tax in D is less restrictive to trade than the existing U.S. tariff of 10.8% to be removed in A, the combination of A and D would move us *towards* free trade[2], with clear benefit to both countries detailed below.

A and B - - the reduction in the U.S. tariff and the substantial return of U.S. treasury deposits - - would be clearly in Canada's economic interest. The surprise is that this could also be true of our two accommodations to the U.S.: C (a change in stumpage policy) and D (a Canadian export tax).

A CHANGE IN STUMPAGE POLICY

The stumpage fee is the price that Canadian lumber producers, in particular in B.C., pay the provincial government for the right to cut logs off Crown Lands. While the Americans view this as government assistance to Canadian production and export, the letter of the law in trade litigation is whether it is *legally* a "subsidy"?

Why do the Americans consider stumpage policy as a form of government assistance for Canadian exports, whether or not it is legally a subsidy? The reason is that the favourable cost of

[2] On March 17 NAFTA ruled that the U.S. tariff should be reduced from 10.8% to 2.1%. If the U.S. were to quickly and completely respond, A and D would reduce simply to the recommendation that 2.1% U.S. tariff be replaced by a 2.1% Canadian export tax. However, given the possibility of U.S. legal delay and appeal - - including a possible Extraordinary Challenge which, based on recent experience, the U.S. might, or might not accept, it is far from clear when - - or even if - - the U.S. will cut its present tariff, and if so, by how much. Given this uncertainty, our analysis is based on the present 10.8% U.S. tariff. However, we do address below the implications of a possible prior U.S. tariff reduction in response to the March 17 judgment.

this government-set fee (relative to the auction cost of the right to harvest timber in the U.S.) provides relief to Canadian firms under pressure to cut production. This conclusion seems to receive support at least implicitly from Canadian firms and labor that defend this stumpage system. The objective of the U.S. is a Canadian stumpage fee determined by a free market process such as an auction.

What's wrong with auctioning off stumpage rights, even if this would mean a higher, market-determined price of logs? Why shouldn't provincial citizens acquire full value for the renewable resources taken from Crown Lands? As we move to free trade, do we really want to risk having in place an incentive for the overcutting of our forests? Would it not be better for provincial governments (in particular, BC) to charge what the market says these resources are worth (even this amount may, for conservation reasons, not be enough in the long term[3]) and use the extra proceeds, e.g., to encourage reforestation?

AN END TO RESTRICTIONS ON LOG EXPORTS

Internationally competitive stumpage fees require auction markets open to foreign participants, hence an end to BC restrictions on log exports that prevent foreign firms from bidding.

By keeping the price of logs in Canada down, these restrictions reduce costs to processing Canadian sawmills. Any suggestion that such assistance be ended is likely to meet the charge that this would 'close down our sawmills'; and the insistence that instead we should continue to assist this processing of logs in Canada as the only way of getting the 'most out of this resource'. But there is a problem with this popular argument that has been confirmed by

[3] While the conservation argument for a sufficiently high fee may become important in the future, it's not clear it is now, because of other BC conservation policies now in place.

experience in other countries: Inefficiencies in processing firms that have to be subsidized may reduce the value of the basic resource; i.e., other factors (in particular labor) apparently so gainfully employed in processing, may actually be producing little or no value added.[4] Thus ill-advised schemes to get the most out of resources may get the least. In oil and natural gas, Canada has generally avoided this; by and large they are exported unprocessed even though these, as non-renewable resources, are in a sense more valuable for Canada in the long run than a renewable resource such as timber.

A key question in any such case is: "Does the processing industry need such a subsidy? If it is internationally competitive then the answer is no, and there would be a temptation to allow subsidization to act as a protective cover for creeping inefficiency (or as a cover to remove pressure to make competitive improvements in efficiency).

In the specific case of the Canadian softwood lumber industry processing logs, the answer seems to be no: past evidence of its strength suggest that this industry does not need subsidization. From March 2002 until December 2005, Canadian firms were able to maintain roughly their traditional one third share of the U.S. market despite the duress caused by the competitive disadvantages they faced from a 27%, then a 20% U.S. tariff and the relatively small Byrd Amendment payments to U.S. producers that doubled their protection. Given the recent U.S. tariff reduction to 10.8%, the end to the Byrd Amendment[5], and the further reduction in U.S. protection down to the x% level in this proposal, it is difficult to argue that the resulting strengthening of the competitive position of Canadian firms would be more than offset by

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[4] For example, see evidence from…...in which labor and other factors employed in processing have created no value added. It would have been better to sell the resource on the high-priced international market and employ the labour and other resources released from processing in other activities. In the extreme case sometimes observed of negative value added, labor is less productive in processing than if it were unemployed.

[5] The Byrd Amendment as it applies to Canada is now essentially dead. Earlier this year Congress repealed it effective in late 2007. To cover the period until then, its payments on imports from Canada or Mexico have been judged illegal by a U.S. court (subject to appeal).

whatever higher price of logs might result from the change in stumpage and log export policy suggested here.[6] Paradoxically, the politically most feasible time to change domestic (stumpage and log) policy is when there is a trade dispute to be resolved, with exporting firms able to offset their higher log costs with the benefits of resolving the trade conflict. (As in any trade negotiation, it may be desirable to phase in changes to allow time for adjustment.)

Negotiating problems would still remain: How and by whom is the decision to be made on when stumpage policy has been adequately changed? In 1991, a Canadian complaint of excessive U.S. interference in our domestic policy contributed to Canadian termination of a Memorandum of Understanding, in some respects similar to the agreement proposed here. However, this problem of undue interference may not be as difficult to resolve as often assumed because some other Canadian provinces have been able to convince the U.S. that their stumpage practices are sufficiently 'free market' to allow them to avoid U.S. tariffs. Moreover, there is a problem with free market auctions: single or oligopsony bidders in remote locations may depress the auction price below its ‘competitive level’. The provincial government may therefore have to set a floor on the stumpage fee there. (However, the U.S. should not object to this form of government price-setting since its concern has been too low a price of logs and this floor would keep the price of logs up.) Moreover, such a government-set price would take account of market auction prices in non-remote locations. (Precisely how is still a difficult issue.)

To sum up: a change in stumpage and log export policy would not only be a key component now in negotiating a long term agreement that both countries can live with. These changes would also cement this agreement in the future since they would remove the grounds the

[6] We emphasize that it cannot be argued that the Canadian softwood lumber industry is necessarily inefficient because it has been receiving assistance from attractive log prices. Indeed, such a conclusion is contradicted by the ability of the industry to maintain its exports into the U.S. market, despite the tariff it has faced there.

The only warranted observations is that, with the reduction in these U.S. trade barriers, there is the risk that *continued* subsidization may allow *future* inefficiency.

U.S. has used in the past for objecting to Canadian stumpage fees. Specifically, the U.S. would be unable legally to impose protection because it could not hope to pass its first NAFTA hurdle - - proof of Canadian subsidization of softwood lumber exports - - and, with its case failing there, the second U.S. hurdle - - proof of injury to the U.S. industry, the focus in the last August furor - - would not even come into play.

A CANADIAN EXPORT TAX

Of course, in the proposed negotiation above, the combination of A, the complete elimination of the U.S. tariff, and C, a Canadian-administered x% export tax of is equivalent to the combination of a reduction in the U.S. tariff to x%, with the remainder replaced by an x% Canadian export tax. This last switch would bring no change in trade flows, production, export or efficiency. The only change would be that the Canadian, rather than the U.S. treasury would collect the revenue, turning an overall loss to Canada to a gain - - technically a clear terms of trade benefit for Canada. Indeed, the resulting gain to Canada would exceed that from a full move to free trade i.e., from the complete removal of the U.S tariff as the result, for example, of 100% success in current legal action. The only condition for this surprising conclusion is that the Canadian export tax would not substantially exceed its optimal level, in the “optimal tariff” sense.[7]

[7] What is an optimal export tax? As a country with influence over international price increases its export tax, it (1) benefits from the resulting price increase it receives on its exports, but (2) loses from the decreased volume it exports. As it increases this tax, it increases its net benefit so long as (1) continues to exceed (2). But eventually an optimal export tax is reached where the volume effect (2) overtakes the price effect (1), and further increases in the export tax are counter productive. The importance of Canadian exports in the U.S. market imply an optimal export tax well above the range around x% in this proposal.

Should free traders be offended by an export tax? Trade theory has always recognized that an importing country - - with influence on international price because of its market size - - can benefit by imposing a limited optimal tariff on its imports. The conclusion here is based on a parallel analysis: a country with sufficiently large exports to have influence over international price can benefit by imposing a limited optimal tax on those exports. In either case, our existing trade agreements (augmented by the threat of retaliation) deter countries from taking such an initial move.

MARKET SHARING: A VOLUNTARY EXPORT RESTRAINT (VER) AS AN ALTERNATIVE TO A CANADIAN EXPORT TAX

Under a VER, Canada would agree to limit exports to a percentage of the U.S. market, with the limited quota rights (‘tickets’) to export into the U.S. market to be held by Canadian producers. If this policy is calibrated to provide the same x% degree of protection to the U.S. (i.e. the same restrictive effect on Canadian exports) it would be broadly similar to a Canadian export tax insofar as it would allow the U.S. industry protection, while providing benefits to Canada above and beyond those available from complete free trade. The major difference is: "Who would get the Canadian benefit?" Under an export tax, the benefit would go to the Canadian treasury collecting the tax. In contrast, under a VER the benefit would go to the Canadian exporters holding the quota rights who would be able to sell in the U.S. at the higher price resulting from the scarcity generated there by the VER.

(Complications are possible on the VER theme, such as a VER with a penalty tariff to be triggered if Canadian exports exceed the quota limit; each country has as interest in administering the penalty tariff. Another possibility is a VER with a penalty that escalates as various trigger points are exceeded. In any case, if no penalties are triggered, the result is the same as a simple VER.)

WHICH IS PREFERABLE – AN EXPORT TAX OR A VER?

A VER may be politically attractive and hence easier to sell, since its benefits go to those who were the chief victims of past U.S. trade restrictions: the exporters now holding the

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But when a trading partner (the U.S.) insists on Canada imposing an export tax as in the agreement proposed here, there is no such problem, since the U.S. will neither retaliate or lodge a complaint.

valuable tickets and indirectly their labor force. Thus a VER avoids a major problem with an export tax: to what degree should the Canadian benefits from the export tax - - the government receipts from collecting the tax - - be held by the federal treasury; or be used in some way to assist previously victimized firms (and risk triggering U.S. retaliation); or be distributed to each province, according to how much its industry has been victimized by U.S. trade action?

However, in other respects a VER is inferior to an export tax. It is more difficult to set up and administer. For example, the division of the total U.S. market between domestic producers and Canadian exporters must initially be negotiated. In this lumber case it may be almost impossible to calibrate a VER to be as protective as the alternative x% export tax because the share of Canadian exports in the U.S. market has not substantially changed in the recent past in response to changes in the U.S. tariff. This inelasticity of response is not just a mystery in itself. It also means that we can't count on econometric estimation to yield a VER equivalent to an x% Canadian export tax. With the negotiators accordingly having to resort to an educated guess, it is likely that any VER they are confident will be restrictive enough to effectively limit Canadian exports even minimally will be too high - - i.e., more protective than the x% export tax.

Over time this problem gets worse. How can the division of the U.S. market (between Canadian exporters and domestic U.S. producers) be changed if producers on one side of the border become more efficient than on the other? Behind the protection they receive, will U.S. producers be under less pressure to innovate and otherwise increase efficiency?[8] Within Canada, how is the total Canadian export share to be allocated as quotas to Canadian exporting firms?[9] How are these quotas to be monitored to ensure compliance? When should a new Canadian

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[8] Indeed will the same be true even for each Canadian exporter whose fixed share of the U.S. market will also be 'protected'?

[9] There may also be a problem if trade in quota rights is allowed - - a suggestion often made to increase efficiency: this may lead to increased monopolization.

entrant - - a potential exporting firm - - be granted a quota, and at whose expense? The longer the time frame, the greater the difficulties in administering a VER, because it becomes increasingly difficult to keep up with changing patterns (e.g. in efficiency and timber availability) on both sides of the border.

It is in dealing with such thorny issues that an administered VER is inferior to an export tax that simply changes the price signal and then lets the market respond. Such a tax not only solves the original problem of determining market shares both between Canada and the U.S. and within Canada, but also allows a continuing response over time to innovation and other changes in the industry. Thus a relatively inflexible and hence increasingly inefficient VER generates lower long-term income.

Moreover, a VER may raise serious political problems. Whereas under an export tax, each firm decides on its production volume in response to a market price, under a VER each firm has an incentive to complain about its inequitable treatment, and exercise its political influence on the government to increase its quota, with large, wealthy incumbent firms having an advantage. It may become increasingly difficult for a government to defend the whole host of its own administrative VER decisions on firm-by-firm quotas.

In contrast, under an export tax a government can deflect a complaint that a firm is being treaded inequitably vis-à-vis its Canadian competitors by pointing to the market. But how about complaints by Canadian firms that they are being treated inequitably vis-à-vis their U.S. competition? How does the Canadian government deal with such complaints about the export tax itself? The government can deflect these by stating simply that the export tax can't be changed because it's part of an international agreement, without which Canadian producers would be back in the damaging and uncertain pre-2006 situation.

In short, under either an export tax or a VER, the government may have to face complaints by the entire Canadian industry that it is being inequitably treated vis-à-vis its U.S. competition. But under a VER, there be a whole host of additional complaints, in this case by firms claiming that government decision-making leaves them inequitably treated vis-à-vis their competing firms within Canada.[10] Thus under an export tax, the government is likely to face fewer complaints, and find them easier to answer.

Although either an export tax or VER may be important - - even essential - - to close an agreement, an export tax is greatly preferred, especially since the objective is an agreement that will prevent protectionist drift and will last over time.

Finally, there is a fundamental problem with a VER that would exist even in the absence of all the above complexities. A VER, like any solution based on detailed government administrative decisions, is relatively inefficient. As often illustrated in the case of controlling pollution, you can get 'far more bang for your buck' by changing the market signal (in this case the export tax) and allowing firms, in their market response, to make all the detailed decisions.[11]

Accordingly, a major challenge for the Canadian negotiators will be: if an agreement cannot be struck without Canada providing some protection for the U.S. industry, *hold fast to an*

[10] While a VER will generate more additional complaints of this second kind, an export tax is by no means problem-free. For example, there are some problems, such as barriers to the entry of new firms, that will be difficult under an export tax or a VER.

[11] For example, a Canadian firm that has just developed a more efficient lower cost production technique will be able to expand its exports by easily jumping the x% export tax. On the other hand, another Canadian producer, unable to keep pace with even modest improvements in the North American industry, and thus less able to jump the tax and compete in the U.S. market, will be under pressure to reduce its exports. On balance the result may be the same restriction on the Canadian share of the U.S. market as a VER. But the difference is that a VER, by freezing the share of each company (based, say on its past production level) results in greater production in the high-cost country and hence lower total income.

export tax. (Indeed if the VER option cannot be avoided now[12], a strong case can be made for negotiating an agreed-upon route for future conversion to an export tax - - not easy, since such conversion may be strongly resisted by U.S. firms that may correctly or incorrectly perceive that the protection they are by then receiving from the VER may have drifted above the x% export tax level that is about to be imposed.) It would be far easier to negotiate an export tax now.

WHY THIS PACKAGE COULD BROADLY BENEFIT CANADIANS

1. ***Effects on Canadian exporting firms and their labour force***. Insofar as the costs of Canadian firms are increased by the introduction of a market-determined stumpage fee, this will eliminate this buffer that these firms (and indirectly their labour force) have been acquiring, especially in a recession. They are likely to also face a higher price of logs. On the other hand, these firms and their labour would benefit from (1) substantial repayment of past duty collections by the U.S. treasury; and (2) the more open border for their exports that would result now from the substantial move towards free trade as protection for the U.S. industry is reduced to x%.[13]

To these effects from resolving this dispute would be added benefit (3), the assurance that such an agreement that both countries can live with would provide the Canadian industry with far superior insulation against future U.S. protective actions that have been so costly in the past. More broadly there will be a benefit (4) to *all* Canadian export sectors and their suppliers because of the elimination of the risk that continued hostilities in softwood lumber will shake

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[12] Perhaps because of support by the U.S. industry for protection that will drift higher as market share remains constant. There may also be support for the VER option by the Canadian industry less concerned with this damaging drift than with its desire to acquire VER 'ticket income'.

[13] If a VER protecting the U.S. industry cannot be avoided, then Canadian firms holding the quotas and indirectly their labour force would further benefit.

confidence in and weaken NAFTA.[14] Our cited example was the firestorm last August of public protest against the U.S. disregard of a NAFTA panel decision favouring Canada; this spilled over into calls that because of this failure of NAFTA's due process, NAFTA itself had failed and Canada should withdraw. On this occasion nothing concrete came of these or more moderate attacks on NAFTA, with the recognition that NAFTA has, by and large, been successfully governing the broad bulk of our trade. Moreover, there is a continued risk that an unresolved softwood lumber dispute will shake confidence in NAFTA in the U.S. as well. The strongest expression of this is the current legal claim by the U.S. industry that the U.S. constitution was violated when the U.S. President and Congress "outsourced" control over U.S. laws to NAFTA's dispute-settlement panels. The prospect that such a claim could succeed in any way is frightening, no matter how unlikely.

2. ***Canadian taxpayers***. They would benefit from relief from the various fiscal drains caused by this unresolved dispute, including both the legal costs and the assistance to the victims of this dispute. (Recent Quebec relief announced for the industry and proposed federal loan guarantees are examples, with such assistance viewed by U.S. softwood lumber interests as an export subsidy adding fuel to the fire.)

If the proposed x% Canadian-administered protection for the U.S. is in the form of an export tax, taxpayers would also benefit from increased Canadian treasury receipts that could be used in a variety of ways, e.g., tax reduction.

[14] Suppose that, prior to this agreement, the U.S. fully complies with the March NAFTA ruling by reducing its tariff to x%. Then there would be no high U.S. tariff to remove and the agreement would only switch the administration of that x% American protection from the U.S. to Canada. With gain (2) above already accomplished, the benefits to Canadian firms and labor would be (1), (3) and (4). (Even if the U.S. does not quickly reduce its high tariff, this NAFTA ruling - - by strengthening Canada's bargaining position in the negotiations - - provides an example of a positive payoff from Canadian legal action which has sometimes been successful, sometimes not.)

3. ***Any exceptions?*** The U.S. tariff has been "backing up" Canadian lumber production into the domestic market resulting in a lower price than would otherwise prevail. Reduction of that U.S. protection will accordingly leave lumber purchasers in Canada facing a less favourable price. In export sectors, any move towards free trade - - including a move to complete free trade - - has this one con among many pros.[15] But even then, the only Canadian lumber purchasers who would lose overall would be those not compensated by free trade benefits such as greater employment opportunities.

ECONOMIC EFFECTS ON THE U.S.

This agreement would provide economy-wide benefits to the U.S. insofar as it would ensure against negative spillover effects of this dispute on NAFTA and hence North American trade in all sectors.

What would be the effects specifically on the U.S. softwood lumber industry? With the reduction in its protection and the resulting freer entry of Canadian lumber into the American market, U.S. house builders and buyers would benefit from lower prices. This would more than offset the loss to U.S. producers who would face a lower price.[16] Indeed, this loss to producers would be even less; it would be partly offset by gains from changes in Canadian policies: namely major benefits to U.S. producers from (1) the far more secure protection that they would acquire from Canada; (2) their improved access to Canadian logs, and (3) their increased ability to compete with Canadian firms as a result of changes in provincial stumpage fees.

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[15] Indeed, under complete free trade this cost would be even higher. Thus this is not a cost of the Canadian export tax; instead the tax moderates this cost.

[16] This is the conclusion of the standard analysis of the effects on a country of only reducing its own tariff assuming no changes in partner's policies.

But wouldn't there be one clear and substantial U.S. loser: the U.S. treasury that would no longer collect duty revenue on Canadian imports? But this greatly overstates its loss because its collections from Canada have not been duty revenue per se, but only "deposits" liable to be returned to Canada.[17]

To sum up: in large part based on the unambiguous importance of the price reduction to U.S. buyers, special benefits to U.S. producers from changes in Canadian policy, and the questionable nature of U.S. losses in duty revenue, the expectation is that even in strictly economic terms, the U.S. would be likely (but not guaranteed) to acquire a net economic gain from our proposed package.

WHY IS SUCH AN AGREEMENT POSSIBLE?

Why should the U.S. sign an agreement economically so beneficial to Canada?

Why not? True, in economic terms this agreement would be particularly beneficial to Canada including all its interested groups; but the U.S. could also expect to benefit. While it is true that purely economic benefits to the U.S. would not be guaranteed, in broader political economy terms the U.S. negotiators would be assured a benefit because they would achieve their major objective of providing their industry with some protection. Although protection of the U.S. industry would be at a lower level, it would be much more secure because it will no longer be at risk either from Canadian legal attack or the sort of downward reassessment by the U.S. authorities that occurred last December 12. (In the negotiations, Canada would need to commit not to remove its protection for the U.S industry (i.e. its export tax) without U.S. agreement.)

[17] Therein lies an answer to the theoretical puzzle: As part of this policy package, the U.S. would be removing its tariff. Wouldn't the U.S., as a country influencing world price, lose the terms-of-trade benefit that its tariff has been providing? The answer would be yes, were the U.S. treasury cleanly collecting all duties on imports from Canada. But it is not. It is only collecting deposits liable to be returned to Canada.

This continued protection is important for a U.S. administration seeking the votes of those in Congress (and especially the Senate) that are sympathetic to U.S. lumber producers.

This is an example how (all?) governments focus not on the broad interests of all groups, but instead on the interests of producers. Thus the important question is whether a politically critical group of producers that insists on protection gets it, now how. This is the reason why the U.S. has favourably judged and supported - - in some cases pressed for - - this sort of policy in the past. Examples include American pressure on Japan to impose VERs on its auto exports to the U.S. Moreover on two occasions, the U.S. has agreed to Canadian taxes (in different forms) on our lumber exports. These precedents not only tend to confirm that the U.S views such deals as not only providing political economy benefits. They also suggest that it may be easier for the Canadian government to negotiate this sort of agreement with the U.S. than to sell it to Canadian interest groups that would benefit but incorrectly perceive that they would be damaged.