INTRODUCTION

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The papers and notes that comprise this set of CUSTAC Occasional Papers (Numbers 6, 7, and 8) focus on the nature and effects of subsidies granted by US and Canadian governments to domestic producers. The papers originated as symposium presentations at the Canada-United States Legal Studies Centre, University at Buffalo Law School, in the spring of 1990. The purpose of the symposium, and of these papers, is to come to some understanding of the issues involved as the two countries attempt to decide what form of domestic subsidies are to be allowed in the two-year-old free trade area of Canada and the United States.

If anyone thought that the late-1988 signing of the Canada-United States Free Trade Agreement (FTA) settled the controversy about the rules and nature of the world's largest bilateral trade flow, the succeeding years have surely convinced him or her otherwise. Questions remain and grow: some questions, like the exact workings of the dispute-settlement process or the definition of allowable internal subsides, were clearly and deliberately left for further discussion. Other questions, like the role that subsidy negotiation will play in proposed Canada-U.S.-Mexico trade talks, were not so obvious in 1988. Certain mutual goals, such as the removal of agricultural subsides, were worded to recognize the salience of the Uruguay Round of GATT negotiations, which did not conclude in December 1990 as planned. The impact of the proposed trilateral discussions and the conclusion of the GATT round are still very unclear. Therefore, these Occasional Papers grapple with the first set of uncertainties -- how should the intent of the FTA's Chapter 19, "to develop more effective rules and disciplines concerning the use of government subsidies"[1] be implemented?

The United States has been especially slow to recognize the magnitude of its own direct and indirect subsides, and has been slow to measure domestic and foreign subsides systematically.[2] the papers by Harry Baumes and John Ragosta develop methodologies for systematic measurement of subsidies in the agricultural and natural-resource sectors, respectively. The papers by Erna Van Duren and Jeffrey Thomas introduce the nature of subsidies in these two sectors, and analyze the political and legal influence that the GATT negotiations could have on the bilateral negotiation called for by the FTA's Chapter 19. Van Duren's and Baumes's papers appears in Occasional Paper 6, while Ragosta's paper comprises Paper 7a.

Subsidies to manufacturing industries and to disadvantaged regions are the topic of the three papers and two abstracts collected in Occasional Paper 8. The federal and subnational

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[1] Canada-United States Free Trade Agreement, Article 1907, Section 1(a).

[2] Morton, C.S. 1989. Subsidies Negotiations and the Politics of Trade. Canada-US Outlook 1 (1). Washington, DC: National Planning Association.

governments in the two countries choose, sometimes implicitly, among many different interests that can be protected by subsidies: from mobile, large corporations to more region-specific workers and small firms.[3] Bruce Fountain notes the wide range of points at which a government can assist the private procurement, production, or sale of manufactures. This range of potential actions complicates the task of subsidy measurement and assessment. Richard Diamond abstracts from his article, published elsewhere, which searches for the basic principle underlying U.S. use of countervailing duties. He finds no consistency among the stated basis (reducing economic distortion), the more likely basis (allowing U.S. producers the same returns as if there were no foreign subsidy), and the actual practice (response to industry complaint). This inconsistency complicates the practice and predictability of countervail.

Also in Occasional Paper 8, Jean Anderson reviews some subsidy and countervailing-duty concept whose bilateral interpretation will determine the potential for agreement. The proposals from Canada and the U.S. to the Uruguay Round yielded some insight into the two countries' interpretations. Leslie Delagran argues that regional subsidies available across sectors (more common in Canada) have few identifiable trade-distorting effects, and should not be subject to countervailing duty. The more *ad hoc* patchwork of U.S. local, regional, and state location incentives is even harder to measure, and may in practice be more sectorally focused. However, the domestically oriented nature of U.S. manufacturing obscures the trade distortion of these subsidies and incentives (while the import-substitution effects may be substantial but un-monitored[4]). The note by Anthony Marconi provides a glimpse of this patchwork, by reference to the set of incentives available in western New York State.

Laura Mangan of the Canada-U.S. Legal Studies Centre (and now of the Baldy Center for Law and Policy, also at the University at Buffalo) has done an excellent job of encouraging (and when necessary, cajoling) authors, and of editing papers. Thanks also to Research Assistant Alice Elder who was instrumental in organizing speakers for the symposium and initial editing of their papers and to Dawn Baksh who took on the unenviable task of transcribing the symposium proceedings. Jim McConnell and the Canada-U.S. Trade Center have encouraged and financed this venture, in part with the support of the Canadian Embassy and UB's Canadian-American Studies Committee.

Finally, I sincerely thank the authors for their efforts and their insights.

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3 Morici, P. 1990, Industrial policy technology, and the Canada-U.S. Free Trade Agreement. Business in the Contemporary World 3(1): 101-110.

4 Grey, R. de C. 1981. Trade Policy in the 1980s: An Agenda for Canadian-U.S. Relations. Montreal: C.D. Howe Institute.

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NATURAL RESOURCE SUBSIDIES AND THE FREE TRADE AGREEMENT:
Economic Justice and the Need for Subsidy Discipline

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NATURAL RESOURCE SUBSIDIES AND THE FREE TRADE AGREEMENT: Economic Justice and the Need for Subsidy Discipline

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Many have freely criticized U.S. and Canadian countervailing duty (CVD) laws. Criticism against the U.S. law in the field of natural resource subsidies has been particularly harsh. Yet, the countervailing duty law is necessary. Free trade will not simply happen. It is necessary to take countervailing action if subsidies are to be effectively disciplined.

Taking a U.S. perspective, this paper concludes that the countervailing duty law and any agreement developed by the FTA's Subsidies Working Group[2] must address natural resource pricing.

It is worth noting that my experience with natural resource subsidies grows primarily from successful efforts on behalf of the U.S. Coalition for Fair Lumber Imports in the 1986 CVD case against subsidized Canadian lumber (Lumber II), one of the most acrimonious CVD cases in history. That is not entirely inappropriate. Not only has that case been a central focus of Canadian efforts to have the U.S. countervailing duty law modified, but in many respects it is a paradigm for resource subsidy cases.

I. PUTTING NATURAL RESOURCE SUBSIDIES IN CONTEXT

A. Why We Countervail

Various rationales have been given for use of countervailing duties. Often it is suggested that countervailing duties are a response to distortions of trade and markets which lower the overall efficiency and wealth of the world. If this is the purpose of the CVD law, the law should be structured to always seek the response most closely resembling the market, i.e.,

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[1] The author is an attorney in the Washington, D.C. office of Dewey, Ballantine, where he was intimately involved in representing the U.S. industry in the 1986 countervailing duty action against subsidized Canadian lumber. The conclusions in this paper are the author's, and not those of Dewey, Ballantine or the U.S. lumber industry.

[2] Article 1907(a) of the Free Trade Agreement calls for establishment of a Working Group to "develop more effective rules and disciplines concerning the use of government subsidies." Article 1906 provides that the system of dispute resolution in Chapter 19 will only be effective for five years, with a possible two year extension, pending results from the Subsidies Working Group. Failure of either nation to agree to implement a proposed subsidy regime would allow either country to terminate the FTA on six months notice.

the most efficient allocation of resources. This is often, however, not the result of the CVD law.

There is another rational for the countervailing duty law arising out of sectoral economic concerns. As a matter of "economic justice," we expect that a person should have to compete against other persons at home and abroad, but should not have to compete against the government (domestic or foreign).[3]

The concept of economic justice, having broad appeal to the American worker and entrepreneur, is undoubtedly part of what motivates the majority of Congress to support the countervailing duty law. Any U.S./Canada subsidy agreement will have to address the problem of economic justice for American workers.

Thus, for example, Senator Moynihan's approach to dumped or subsidized raspberries -- to have them on breakfast cereal[4] -- is not a helpful or realistic approach to the problem of subsidies in the United States or in U.S./Canada trade relations. Senator Moynihan evidently does not consider concepts of economic justice in evaluating trade disputes because he apparently never earned his living growing or picking raspberries and apparently does not empathize with those that do.

In fact, both concepts -- economic justice and trade distortion -- underlie the countervailing duty law. Some policy-makers base their decisions primarily on concepts of economic justice (many in Congress are in this group) and some on concepts of trade distortion (taken at their word, policy-makers in Commerce's International Trade Administration are predominately in this group). In any case, these concepts have not been applied in a restrictive manner.

B. Subsidies in the Context of U.S./Canada Relations

As many have observed, with few exceptions the amount of trade involved in CVD cases is small compared to the attention given the issue in bilateral trade relations.[5] On the other hand, considering sectoral effects (economic justice is largely a sectoral concept), many

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[3] Others have labelled this concept "domestic entitlement." See discussion in Diamond, Economic Foundations of Countervailing Duty Law, 29 Va. J. Int'l L. 767, 780-81 (1989).

[4] Senator Moynihan once flippantly expressed his support for dumped Canadian raspberries, noting that such dumping "sounds kind of pleasant with spring time." "Oversight of the United States-Canada Free Trade Agreement," Hearing before the Subcommittee on International Trade of the Committee on Finance, S. Hrg. 101-204, 14 (April 7, 1989).

[5] Two-way U.S.-Canada trade in 1985 totaled $125 billion, P. Wonnacott, The United States and Canada: The Quest for Free Trade, 2 (Institute for Int'l Econ. 1987), and Canadian imports actually made subject to U.S. countervailing duties from 1980 through 1987 totalled only about $160 million on an annual basis. See M.J. Anderson and J.T. Fried, "Subsidies and Countervailing Duties in the United States-Canada Free Trade Agreement," in The U.S./Canada Free Trade Agreement, Practising Law Institute, 133, 140 (1989).

U.S. industries have reason to be concerned about Canadian subsidies (as many Canadian industries have, no doubt, reason to be concerned about U.S. subsidies).[6]

Studies have noted that, overall, Canada provides far more subsidies on a percentage of GDP basis than the United States.[7] Perhaps as important, however, is the potential affect of "domestic" Canadian subsidies on the volume and value of exports. An enormous proportion of Canada's merchandise exports are imported into the United States. In 1985, almost 80% of Canada's merchandise exports entered the United States, compared to 59.3% in the 1960s. At the same time, Canada's exports totalled almost 30% of GNP.[8] With lumber, for example, almost two-thirds of Canadian production was exported to the United States. Thus, as one commentator put it, Canadian subsidies are "more likely to be perceived to have a direct impact on bilateral trade."[9]

By comparison, while U.S. resource subsidies, e.g. water and grazing rights, may be wealth redistributing, they are not essentially export-oriented. Foreign industries tend not to be directly injured and, in any case, it might be extremely difficult for a foreign industry to demonstrate injury within the meaning of the GATT.[10]

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6 The softwood lumber dispute, for example, was massive; at the time it was filed Canada exported approximately $3 billion ($US) of softwood lumber to the United States annually (and the value of exports has remained relatively constant since that time). The U.S. industry requested duties of up to more than 36% f.o.b. mill.

7 See Hufbauer, "A View of the Forest," in Subsidies and Countervailing Measures, B. Balassa (ed.), World Bank Discussion Paper No. 55, 13-25 (1989).

8 See P. Wonnacott, The United States and Canada: the Quest for Free Trade, the Institute for International Economics, 59-60 (1987).

9 Hart, The Canada-United States Working Group at 12.

10 As Jeffrey Thomas indicated at the conference, the fact that many U.S. subsidies do not generate large volumes of exports does not mean that they do not injure Canadian industries which might otherwise be able to export more to the United States. Theoretically it would be advantageous -- both based on market factors and economic justice -- to address this type of subsidy effect. On the other hand, to the extent that the "sovereignty" argument for not countervailing, discussed below, has any validity, it must be in the domestic effects of domestic subsidies. Second, CVDs also do not address the deleterious effects of subsidies in third country markets. Perhaps these two factors are, in some way, offsetting. In any case, the purely domestic effects of subsidies are not actionable under the GATT. Hart opines that "export effects are recognized to be bad whereas import displacement effects are not. The first can lead to countervail, the second to gnashing of teeth." Hart, The Canada-United States Working Group, at 12.

II. YES, CANADA, THERE ARE NATURAL RESOURCE SUBSIDIES

A. Rationale for Countervailing Natural Resource Subsidies

The rationale for countervailing duties discussed above applies fully to natural resource subsidies. Perhaps this can best be illustrated with an example. Suppose that a foreign government were to make a long-term commitment to give a specific industry money to cover operating expenses. This is certainly a countervailable subsidy. Were the government to give the industry $1 for a 10¢ "payment," it would still be a countervailable subsidy. Now suppose that the government sells the company gold from a government gold mine for $10/ounce when the gold cost $10/ounce to mine and process. Most would agree that this is a subsidy. The answer should not be different if the government sells the right to remove the gold rather than the gold itself.

Difficult questions concerning when the resource or removal right is given to a specific industry and what is the measure of the subsidy can be addressed, as with any subsidy, through the principles of specificity and preferentiality.

B. Natural Resource Subsidies Are Not a Sovereign Right

In the softwood lumber countervailing duty case, many urged that natural resource pricing should be exempt from countervailing duties as a sovereign function. This makes no sense.

Every government has the right to price its resources as it pleases. Just as it has the right to provide domestic subsidies. When subsidized goods enter the territory of another country, however, it is that country's sovereign right to countervail injurious foreign subsidies.

The issue of countervailing natural resource subsidies which result in injurious exports must be distinguished, however, from the question of domestic pricing of a government-owned resource, which is a sovereign right. After the adoption of the Softwood Lumber Memorandum of Understanding (MOU), some of the Canadian provinces agreed to increase their timber fees in order to eliminate or partially eliminate the export tax on lumber. In order to do so, these provinces had to convince the U.S. Government that the stumpage increase would properly replace the export tax.[11] This analysis inevitably involved the U.S. Government in provincial resource pricing if the province later wished to modify the timber fees which had been adopted as replacement measures.

This is not surprising, nor a violation of Canada's sovereignty. In signing the MOU, Canada agreed to this procedure. In the process, Canada sacrificed some of its sovereignty. At the same time, the United States sacrificed its sovereign right to impose a countervailing duty. Such bilateral, agreed limitations of sovereignty are not uncommon in international law.

C. Natural Resource Subsidies Are Not Merely Excess Economic Rent

During Lumber II, the Canadian industry and the U.S. Federal Trade Commission argued that Canadian stumpage fees should not be countervailed because, even if the fees

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11 See The U.S./Canada Softwood Lumber Memorandum of Understanding, ¶ 5(b) (1986).

were below the resource's market value,[12] the difference in the price and value was merely excess economic rent which would end up in the pocket of the timber harvester without affecting his output or price.

This argument ignored the facts and applied static economic theory to a dynamic situation. First, Ricardo's theory of economic rent assumes that the amount of resource available (in his example: land) was fixed and all of the resource would be used as long as the price was at or below market value. In fact, the volume of timber subject to harvest in any given year is not fixed and, given the need to adjust harvests to reflect market conditions and conservation of the resource, should not be fixed. Licensees in British Columbia, for example, were permitted to harvest up to 50% above or below their annual allowable cut (AAC) in any particular year (with a smaller margin permitted over a 5 year period). Moreover, the concept of AAC is not a precise one. Neither the province nor the industry was limited by the theoretical AAC. Thus, the U.S. Coalition demonstrated that in some areas British Columbia had allocated up to 138% of the AAC.

Furthermore, even if the timber fees were classic economic rent -- merely permitting B.C. timber barons to pocket millions of dollars annually in the static model urged by the Canadian industry and the FTC -- over time, this excess rent would encourage increased investment and production in Canada.[13] Put simply, if a lumber company wanted to put in place new equipment and excess rent was available when timber was harvested in Canada, investment would tend toward Canada.

D. The Peculiarities of Natural Resource Subsidies

This is not to suggest that natural resource subsidies have no peculiarities. First, resource subsidies will often be upstream subsidies within the meaning of the countervailing duty law.[14] The Canadian industry, however, did not argue that stumpage fees were upstream subsidies, with the possibility of postponing any decision.

Second, since resource subsidies are usually in the form of low priced goods or removal rights, if the resource (after removal) can be transported out of the country, it could be argued that the subsidy should not be countervailed. If the subsidy is freely available to manufacturers outside of the country, then it does not distort trade. This concept was reflected in much of

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[12] A fact which was well established in the case and eventually admitted by the Premier and the acting and a former Minister of Forests in British Columbia, the Ontario Royal Commission on the Northern Environment, representatives of the Maritime provinces' lumber industry, and many others.

[13] Even supporters of the economic rent theory note grudgingly that "[i]n bad times it is conceivable that the failure to capture all the rents may enable a producer to survive a prolonged slump." Anderson and Cairns, Resource Politics, XIV Canadian Public Policy at 189. Of course, "bad times" are when U.S. industries are most susceptible to injury from subsidized imports. The same authors note in their penultimate endnote that "the possibility of incomplete rent capture cannot be ruled out" with respect to provincial timber. Id. at 195 n.3.

[14] See 19 U.S.C. § 1677-1(a).

the draft natural resource legislation.[15] When dealing with simple cases of dual pricing of transportable goods, as may occur with energy resources, this approach may make sense.[16]

There are, however, several problems with this concept. Resources often have a high weight to value ratio, making export impractical economically. (Logs, for example, are usually not transported more than several hundred miles.) Further, the Canadian provinces effectively ban the export of logs.

Third, natural resource subsidies raise serious questions of resource allocation. Low resource prices often encourage over-removal and discourage governments from incurring the cost of adequate environmental protection, such as replanting timber. As one commentator noted: natural resource subsidies result in a decline of world welfare "as precious resources are wasted through use by inefficient manufacturers."[17] For example, the relatively poor record of the Canadian provinces on reforestation through 1985 can arguably be traced to the ridiculously low prices charged for timber.

Finally, while it should have no substantive effect on the legal matters under discussion, natural resource subsidies are particularly contentious in Canada because of the great extent to which the Canadian economy continues to be dependent upon resource industries.

III. FINDING AND MEASURING NATURAL RESOURCE SUBSIDIES

The real difficulty with resource subsidies is caused by specificity and preferentiality (a measurement of subsidies).

A. General Availability

The illustrative list of subsidies in 19 U.S.C. § 1677(5) defines as countervailable domestic subsidies "provided or required by government action to [be given to] a specific enterprise or industry, or group of enterprises or industries. . . "[18] This illustrative description

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[15] More recently, Jean Anderson, formerly General Counsel of the Commerce Department's International Trade Administration, urged a similar result. See Lewington, "U.S.-Canada Subsidy Row About More Than Just Trade," The Globe and Mail, Toronto, July 24, 1989.

[16] See Nance, Natural Resource Pricing, 30 Harvard Int'l L.J. at 71.

[17] Nance, Natural Resource Pricing, 30 Harvard Int'l L.J. at 113. In addition, as was noted in Lumber II, the resource subsidy can result in high profits, resulting in high investment, resulting in new, efficient equipment without proper consideration of resource availability.

[18] The GATT Agreement on Interpretation and Application of Articles VI, XVI, and XXIII (Subsidies Code) provides only that domestic subsidies are "normally granted either regionally or by sector." Subsidies Code, art. 11:1 (emphasis added). Thus, arguments that specificity is explicitly a GATT requirement, see, e.g., Testimony of Michael Smith before the Trade Subcommittee of the Senate Finance Committee,

(continued...)

of a countervailable subsidy has been taken by the Department of Commerce to require that subsidies be provided to a specific industry to be countervailed.

Various rationale have been developed for this general availability doctrine. Arguably, it is intended to prevent the countervailing of subsidies that do not distort the market but, rather, take money from taxpayers and redistribute it in generally similar proportions. Alternatively, general availability is a more pragmatic concept, limiting the countervailability of important social subsidies (e.g., roads, education, etc.). Whatever the rationale, properly applied, it should not normally prevent the countervailing of natural resource subsidies that are, in fact, used by a limited group of industries or when a limited group of firms or industries is targeted for government benefits.

1. De Jure Specificity and Inherent Characteristics

In the 1982 lumber case, Commerce claimed to reject an analysis of general availability which would have only found a subsidy to be specific if the legislation or regulation creating the subsidy explicitly limited the availability of the subsidy to a specific industry or group -- de jure specificity. The Commerce Department claimed to find Canadian timber subsidies to be generally available because their use was not limited by law but rather by the inherent characteristics of the resource.[19] This was a ridiculous conclusion.

Under this analysis, if a government provides iron ore at a small fraction of its value and lo and behold of almost all of the ore is purchased by steel manufacturers, the subsidy would be considered to be generally available because it is the inherent characteristics of the ore which limit its use. Numerous other examples are possible. Obviously, if this analysis were adopted, a government interested in subsidizing a resource-intensive industry could simply rely on the inherent characteristics of a resource to make any subsidy immune from a countervailing duty.

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[18](...continued)
at 1-2 (June 26, 1986) and Bello and Holmer, Subsidies and Natural Resources: Congress Rejects a Lateral Attack on the Specificity Test, 18 Geo. Wash. J. Int'l L. and Econ. 297, 304 (1984) (paraphrasing the Subsidies Code to ignore its illustrative nature), are on weak ground. Compare Testimony of Professor Gary Hufbauer before the Trade Subcommittee of the Senate Finance Committee, 1-2 (June 26, 1986) (urging that injury is the only clear GATT requirement for countervailing subsidies).

By comparison, the Chairmen of the Subcommittees on Trade of the House Ways and Means Committee and the Senate Finance Committee have both urged that U.S. law includes no general availability requirement. See Nance, Natural Resource Pricing, 30 Harvard Int'l L.J. at 78-79.

[19] In Lumber I, the Department found alternatively that stumpage was generally available because it was used by the lumber, plywood, paper and furniture industries and these industries were not a specific group of industries. One reason for finding this group of industries non-specific was that these industries were classified in different SIC (Standard Industrial Classification) codes.

In fact, the 1984 Brazilian steel case implicitly rejected this concept. In that case, Commerce focused on who was the dominant user of the resource, iron ore.[20] Use of the inherent characteristics concept in Lumber I, and later in the early administrative carbon black decisions, was never explained. The concept of de facto specificity was fully embraced by the CIT in the appeal from the carbon black decision, Cabot Corp. v. United States.[21] The CIT held that if a subsidy was in fact used only by a specific industry or group of industries the subsidy could be countervailed. Commerce finally rejected the inherent characteristics test in an administrative review after the remand from Cabot.[22] The difficult question is, then: Is use, in fact, limited to a specific industry or group of industries?

2. Finding De Facto Specificity: Lumber II

In the 1986 lumber case, the Department focused on three factors in analyzing general availability. First, does the government by law limit the availability of the subsidy? Second, is there in fact a predominant user of the subsidy? Third, does the government exercise discretion in a manner to limit the availability of the resource?[23] No one questions the first test. Questions do arise, however, with the second and third which focus in different ways on the concept of de facto availability.

a. De Facto Availability is a Reasonable Test

The difficulty with a de facto test is that one must draw a line between when a subsidy is in fact utilized by a specific industry and when it is used by a number of industries. The test advocated in Lumber II was that the specific group of users must be the "dominant users." This was consistent with the position taken by the Commerce Department in the Brazilian steel case.

In lumber, the forest products industry was clearly a dominant user of stumpage, accounting for well over 95 percent of the volume of timber harvested. Even if the forest products industry was viewed as too large to be a group of industries,[24] the lumber industry

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[20] See Certain Carbon Steel Products from Brazil, 49 Fed. Reg. 5157, 5160 (Feb. 10, 1984) (preliminary), reversed on other grounds, 49 Fed. Reg. 17988 (1984). See also Oil Country Tubular Goods from Korea, 49 Fed. Reg. 46776 (Nov. 28, 1984) (ITA examines de facto as well as de jure availability).

[21] 620 F. Supp. 722 (Ct. Int'l Trade 1985).

[22] Carbon Black from Mexico (Preliminary Results of Countervailing Duty Administrative Review), 51 Fed. Reg. 13269, 13271 (April 18, 1986).

[23] See Certain Softwood Lumber Products from Canada, 51 Fed. Reg. 37453, 37456 (DOC 1986), preliminary affirmative countervailing duty determination.

[24] In Lumber I, Commerce found that lumber, plywood, pulp and paper, and furniture industries were not a group of industries. In 1986, Commerce recognized that the furniture industry did not directly purchase stumpage. Moreover, given the interdependence, corporate concentration and relations and other factors for the lumber, plywood, and pulp and paper manufacturers, the Coalition argued that (continued...)

was responsible for about two-thirds of the harvest. Moreover, as sawtimber and pulpwood prices were roughly comparable in the provinces, even though sawtimber was far more valuable, the lumber industry was receiving a far higher level of the subsidy, well in excess of three-quarters. The lumber industry should have simply been found to be a dominant user and the discussion of general availability ended. Unfortunately, the rationale for the Lumber II decision was not that simple.

b. Discretion

Commerce indicated in Lumber II that the exercise of government discretion in allocation of a resource would result in a finding of specificity. As a factual matter, substantial discretion had been exercised in allocation of provincial stumpage to ensure that it was utilized by lumber mills.

At least one Canadian commentator believed that the use of the discretion test would effectively eliminate the requirement of specificity. "If the ITA's decision [discretion = specificity] were to be treated as legal precedent and analyzed for the purpose of distilling its ratio, one would be driven to the bald assertion that government ownership of resources is unfair."[25] This hyperbole is unfair. Commerce clearly intended that discretion require some degree of targeting, i.e. intentional government action (through the exercise of discretion rather than legislation) to increase the allocation of a subsidy to a particular industry or group of industries. Interpreted in this manner, there are few theoretical problems with the discretion factor (although it will inevitably lead to some interesting litigation).

B. Preferentiality

The U.S. CVD law indicates that bounties and grants are to be countervailed. An illustrative list of such countervailable subsidies includes the provision of goods and services at preferential rates. Assuming that the use of the term "preferential" in this context means something other than on terms inconsistent with commercial considerations,[26] Commerce has failed to offer a persuasive reason why the statute should not permit the countervailing of "non-preferential" provision of goods and services if those goods and services otherwise provide

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[24](...continued)
these were a close-knit group of industries. Commerce never definitively decided this issue.

[25] Yoder, The Canadian Forest Products Industry and U.S. Trade Laws, Resources, the Newsletter of the Canadian Institute of Resources Law, No. 17 (Winter 1987).

[26] The dictionary defines preferential as meaning "1. of, relating to, or showing preference: offering, or constituting an advantage. . . ." Webster's Third New International Dictionary (Unabridged).

The concept of preferentiality as any benefit seemed to be endorsed by the CIT in the Cabot decision when the court found that a program was countervailable when it conferred a "competitive advantage." Cabot Corporation v. United States, 620 F. Supp. 722, 732 (Ct. Int'l Trade 1985), quoting, British Steel Corp. v. United States, 605 F. Supp. 286, 294 (Ct. Int'l Trade 1985). See also Zenith Radio Corp. v. United States, 437 U.S. 443 (1978).

bounties or grants. After all, if one accepts the concept that addressing market distortion is the rationale for the countervailing duty law, the subsidy should be measured by the degree of distortion. Thus, the measure of the subsidy on goods and services should be the difference between the government price and the market price.

Even if the illustrative list of subsidies should be considered exclusive, until recently the Department's definition of preferentiality has been problematic. Commerce has interpreted the term "preferential" to mean more favorable to one than to another. In other words, preferentiality had been measured by the difference in the price that the government charged one manufacturer and the price that it charged a different manufacturer.

The problem with this interpretation lies in the relationship between specificity and preferentiality. If, for example, Commerce was comparing a specific rate for a good to a generally available rate for the good, this system made some sense. The generally available price would either not be subsidized or, in any case, would not be countervailable. In either case, it can be argued that the measure of the subsidy should be the difference in the prices. When the benchmark price is not generally available, however, a simple price-to-price analysis leads to nonsensical results.

Imagine, to choose an arbitrary example, a government providing subsidized timber to various industries. The market value of the timber is $100, but plywood manufacturers (a specific industry) are charged $20, and lumber manufacturers (a specific industry) are charged $10. Under the classic Commerce analysis, in a countervailing duty case against the lumber manufacturers, the subsidy to the lumber producers is only $10 -- the difference in the two government prices. No subsidy would be found in a case against the plywood manufacturers. The Preferentiality Appendix was necessary to address this frustrating relationship between specificity and preferentiality.

1. Preferentiality Appendix

In conjunction with the decision on remand of Cabot,[27] the Commerce Department published a preliminary Preferentiality Appendix to address this problem.[28] What the Appendix seems to require, or should require, is that preferentiality be measured as the difference between a generally-available benchmark price and a specific price or, absent a generally-available price, as the difference between a specific price and a market price (with various tests for measuring a market price). Unfortunately, in execution the Appendix was not so simple.

The Preferentiality Appendix lists five alternative measures of preferentiality in descending order of use. The first three measures are based on some concept of domestic

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[27] See Carbon Black from Mexico, 48 Fed. Reg. 29564 (1983) and 51 Fed. Reg. 13269 (1986).

[28] That Appendix, 51 Fed. Reg. 13272 (April 18, 1986), was never made final, but has been incorporated in its entirety (either explicitly or by reference) in the new draft Commerce Department countervailing duty regulations. See 54 Fed. Reg. 23366 (May 31, 1989). Commerce has specifically embraced the rationale for the alternative measures as explained in the original Preferentiality Appendix. Id. at 23372.

price difference, the latter two alternatives are, despite some protestation to the contrary, based on some concept of measuring market value.

a. Domestic Price Differences

The first measure of preferentiality is still the difference in price the government charges one group of producers and another. Wisely, however, Commerce now requires the benchmark price to be "nonselective," i.e. generally available (based on all of the factors discussed above).[29]

Absent such a benchmark, as may often be the case in a resource subsidy case, the Department is to look first to the price charged by the government to a non-selective group for a similar product (adjusted for cost differences between the product under investigation and the similar product) and, second, to the price charged by other sellers within the jurisdiction for an identical good or service.[30] These measures are rational alternatives, but add little to the previous Commerce methodology.

There have, however, been difficulties in application of this third alternative. Commerce recognized that a private price for the good under investigation could be "skewed" by the presence of a government subsidy. Commerce reasoned that if the government failed to provide adequate supplies of the good, private sellers could charge higher, scarcity prices to fill the remaining demand. In Lumber II, however, the U.S. lumber industry provided evidence that, in fact, the presence of low government priced stumpage reduced the price for private stumpage as large companies were able to force small, private timber suppliers to provide stumpage at low prices based upon the availability of cheap government stumpage. In fact, history has proven the U.S. lumber industry's analysis accurate as the price for Small Business Enterprise Program stumpage (sold competitively by the B.C. Government) and private stumpage in British Columbia skyrocketed after non-competitive B.C. Government stumpage fees were increased. Thus, great care must be taken in applying the third alternative.

Absent a non-selective price for the same or similar government goods or for the same goods sold by a private source, however, the Department must turn to alternative measures.

b. Alternative Measures

The alternative measures adopted by the Department, in cases where a generally available benchmark is not available, are intended to "measure the difference between the price the government charges the producers under investigation and prices it would charge absent preference."[31] The Department also explained that, in the context of the difference in a private price and government price, discussed above, "absent preference, the government

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29 See 54 Fed. Reg. 23366, 23381 (May 31, 1989), § 355.44(f)(1).

30 54 Fed. Reg. at 23382. It is worth noting that either of these two methodologies would have resulted in a significant countervailing duty in Lumber II, but were rejected because while such alternative sales existed, they were specific.

31 Preferentiality Appendix, 51 Fed. Reg. 13272 (April 18, 1986) (emphasis added).

would opt to provide the good or service at a price in line with commercial sellers' prices."[32] The same standard should be used in applying the other alternative measures. That is, absent preference -- distortion of the market by providing a subsidy, a competitive advantage -- the government would charge a market price, i.e. a price "reflect[ing] fluctuations in supply, demand, business cycles and other factors. . . ."[33]

i. Cost

The fourth measure of preferentiality is the difference between cost and price. This measure, however, is deficient for natural resources for which the "cost" is difficult to measure or, in any case, may not reflect the value of the subsidy.

Return to the goldmine example. The land in which the gold exists may have cost the government nothing. Giving a private company the right to extract the gold is, however, an enormous subsidy.

Absent use of opportunity cost to measure "cost," this alternative will be deficient in many natural resource subsidy cases. Commerce recognized that cost "may not be workable for certain goods, especially natural resources," because, even if goods may have similar costs to the government, "market forces such as demand may enable a firm to earn a greater profit on one good over the other."[34]

ii. External Prices

Failing all other measures, the Department turns to the difference in the government price for the good and the price charged for the good elsewhere in the world. The Department expresses displeasure with this measure, arguing that it is the "least desirable alternative" because the domestic subsidy is "no longer being defined by its effect on the domestic market. This test does not measure preference within an economy."[35]

In both its preference for a cost test over an external benchmark test and in its simplistic dismissal of an external price test, the Department is wrong. Consideration of a real case with real facts demonstrates the problems with the Department's decision.

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32 Id. at 13273.

33 Id. at 13273.

34 Preferentiality Appendix, 51 Fed. Reg. at 13273.

The suggestion that the use of a profit concept is inconsistent with economic, international and U.S. norms, compare T. J. Potter, "Preferentiality Under the Proposed Regulations," at 250, is without basis. Market participants must make profits. Governments can avoid this necessity only by drawing on their treasuries. This type of competition with government, however, is precisely what the CVD law is intended to prevent.

35 51 Fed. Reg. at 13273.

2. Lumber II and the Preferentiality Appendix

In Lumber II, the Department came to the use of cost as a measure of preferentiality having rejected in-country price-to-price comparisons. The Department faced two problems: first, how to measure the cost, and second, if the cost did not reflect a reasonable price (as is likely to occur in any natural resource case), what additional factors, if any, should be evaluated in measuring the preference provided.

Measuring the cost of timber is not at all an obvious exercise. On the one hand, it can be argued that virgin timber has no cost. Alternatively, most timber producing companies measure the cost of timber by measuring the cost of replacing the timber (including silvicultural treatments for the rotation cycle -- 30 to 120 years) discounted to present value.[36] Faced with this problem, the Department chose a not altogether unreasonable alternative. The Department reasoned that it should not be measuring the cost of timber per se, but rather should measure the cost of delivering stumpage to the market place. This cost can be measured as the cost of administering the stumpage program. This led to a moderate initial subsidy calculation and directly to the second problem.

Having recognized that the direct cost associated with resource extraction may not reflect the value of a natural resource (and thus the price absent preference), Commerce had to find a method of measuring the additional value not reflected in cost or turn to the final alternative measure of preferentiality -- external prices. Commerce mistakenly chose the first course.

To calculate the inherent value not reflected in the cost of administering the stumpage programs, Commerce looked at the price charged for private timber in the provinces.[37] The Canadian industry complained that this was double counting -- that is, Commerce was measuring the value of government stumpage as the value of private stumpage plus cost. On the other hand, the U.S. industry pointed out that Commerce had already found that the private timber prices were not a generally available price. Further, the U.S. industry provided evidence that those prices were depressed (later borne out by changes in B.C. stumpage). Thus, it could be argued that cost plus part of the intrinsic value (represented by the depressed value of private stumpage) should be the benchmark.

All private parties agreed, however, that this methodology was capricious and ridiculously difficult to verify. The U.S. industry urged that, given the inadequacy of cost as a measure, Commerce should have turned to external prices.

As the U.S. industry argued, not any external prices should be used. Rather, the price of similar goods, similarly situated, adjusted for any known difference in value, should be used.

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[36] Using this method of cost accounting, the U.S. Coalition demonstrated that the Canadian provinces provided an enormous subsidy.

[37] For Quebec, Commerce compared the price charged for timber in New Brunswick to the price for government timber in Quebec. This was a peculiar methodology as most of the difficulties of an international cross-border stumpage comparison, with which Commerce claimed to be very concerned, apply equally to a cross-province stumpage comparison. See Rugman & Porteous, The Softwood Lumber Decision of 1986, 2 Review of Int'l Business L. at 53-54.

Thus, in the lumber case, the U.S. industry urged that timber from Maine should be compared to timber in Quebec, timber from Minnesota to timber in Ontario, timber from western Washington to timber from western British Columbia and so on.[38] Further, efforts should be made to adjust for any species difference, climate differences, tax policy differences, etc. While such comparisons are difficult, they are possible and will accurately measure the price which would be charged for a good absent preference. Such comparisons were made by the U.S. industry in Lumber II. Thus, properly applied, an external comparison does measure preference in the jurisdiction.

3. Preferentiality: Some Conclusions

Preferentiality is a difficult theoretical concept and even more difficult to measure in real cases. Ultimately, this was the best, accurate argument on preferentiality that the Canadian industry could produce in Lumber II. This is not, however, a reason to fail to measure preferentiality. Properly applied, and lacking an internal benchmark which is generally available in fact and law, Commerce should use an external price benchmark.

IV. FTA Subsidies Negotiations

It is very difficult to predict how natural resource subsidies will be addressed by the FTA Subsidies Working Group. It is clear, however, that the issues raised above will have to be addressed if the Subsidies Working Group is to be successful.

A. Canadian Goals

Some Canadian Government and private sources listed elimination of U.S. countervailing discipline vis-a-vis Canada as a primary FTA goal.[39] This would be extremely unlikely absent clear and enforceable bilateral subsidy disciplines that are not currently in the cards.

One commentator declared bombastically that:

> It is also unrealistic to expect that free trade talks will eliminate these threats [filing of CVD and antidumping]. To Americans, the right to sue is as much a matter of national identity as are the various cultural sensitivities of Canada to Canadians.[40]

Pat Carney was more realistic when she noted that:

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[38] Some persons mistakenly urged a gross comparison of U.S. timber prices to Canadian timber prices, and the Canadian industry often based its arguments against a cross-border comparison on such a gross comparison. This position was never advocated by the Coalition for Fair Lumber Imports.

[39] See Tougas, Softwood Lumber from Canada, 24 Gonzaga L. Rev. at 162.

[40] Yoder, The Canadian Forest Products Industry and U.S. Trade Laws, Resources, the Newsletter of the Canadian Institute of Resources Law, No. 17 (Winter 1987).

We're not suggesting the Americans abandon their trade laws and we'll abandon ours. We're not going to give up our anti-dumping legislation and they are not going to give up theirs -- particularly those remedies that are part of the GATT.[41]

Perhaps other goals would be more realistic. For example, increasing the de minimis rule or slightly heightening the injury test pose less of a political problem in the United States. Similarly, efforts to more precisely define the operative terms affecting natural resource subsidy cases, such as specificity and preferentiality, is possible.

B. Predictions

It is difficult to make precise predictions about the outcome of the subsidies negotiations other than those discussed above. While the Working Group did meet in November 1989, it will not engage in serious substantive discussions until after the subsidy negotiations are concluded in the Uruguay Round. At that time, if for no other reason than exhaustion, it will be very difficult for a U.S./Canada subsidy discipline to move significantly beyond that achieved in the Round.

Some commentators have argued that the United States will have little interest in reaching a subsidy discipline, particularly on natural resources, because most U.S. subsidies (often adopted for political rather than economic reasons) are consumed domestically and thus not subject to countervail actions. By comparison, Canadian domestic subsidies, including natural resource subsidies, often find their way to the United States in exported products. Canada relies far more on the U.S. market than vice-versa. Thus, the argument goes, the United States has less incentive to enter a deal.[42]

This analysis is faulty in a number of ways. First, the countervailing duty law is a very imperfect method to address the effects of foreign subsidized goods entering into the United States. An effective subsidy mechanism would be very desirable for the United States for all of the reasons that the countervailing duty law is maintained. Second, it is not clear that all or even most of the U.S. domestic subsidies would be countervailable even if products were exported; thus, they may not be the types of subsidies subject to international subsidy discipline. Third, for reasons of broad policy (including broader multilateral subsidy discipline) and principle, U.S. negotiators will diligently seek a reasonable and effective subsidies regime. Fourth, domestic paralysis may occur north of the border. After all, any control on the use of countervailing duties is likely to require some discipline on domestic subsidies, an issue which is politically explosive in Canada.

Unfortunately, given the current status of the subsidy negotiations in the Round, it is impossible to predict precisely what the results will be in that negotiating group. I do predict, however, that some ability to bring natural resource countervailing duty cases will remain.

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[41] See "Carney Says Canada Just Wants Clear Trade," The Sun, Vancouver, B.C., June 3, 1987.

[42] See, e.g., "Government Subsidies Shaping Up as Worrisome Loose End," Financial Post, Toronto, Jan. 2, 1990 (citing Michael Hart of the Canadian Centre for Trade Policy & Law). Gary Horlick has espoused a similar position.