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BEFORE THE UNITED STATES
DEPARTMENT OF COMMERCE

In the Matter of:
CERTAIN SOFTWOOD LUMBER
PRODUCTS FROM CANADA

PRE-HEARING BRIEF BY THE
FEDERAL TRADE COMMISSION

November 26, 1986

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Pre-Hearing Brief by the Federal Trade Commission
on the Countervailing Duty Investigation of Certain
Softwood Lumber Products from Canada

INTRODUCTION AND SUMMARY

On May 19, 1986, the Coalition for Fair Lumber Imports, a group of United States softwood lumber manufacturers and associations representing United States lumber manufacturers, filed a countervailing duty petition with the Department of Commerce ("Department") and the International Trade Commission. The petition alleges that the Canadian softwood lumber industry receives benefits from the Canadian federal and provincial governments that constitute subsidies within the meaning of Section 701 of the Tariff Act of 1930, as amended, 19 U.S.C. § 1671. The major alleged subsidy concerns the level of fees ("stumpage fees")¹ set by the Canadian provincial governments for the rights to harvest softwood timber ("stumpage rights") on government land. The petition alleges that the sale of softwood stumpage to lumber companies at preferential rates confers countervailable benefits on Canadian softwood lumber producers. A secondary allegation is that the Canadian federal and provincial governments subsidize their lumber industry by using

1 We define "stumpage" as standing timber.

government funds to pay for reforestation of public timber lands.² The Department preliminarily determined that provincial stumpage programs confer a net subsidy of 14.542 percent ad valorem, 51 Fed. Reg. 37,453, 37,458 (October 22, 1986), and that reforestation programs do not confer countervailable benefits. Id. at 37,463.

The purpose of this brief is to offer a legal and economic analysis for application of the countervailing duty statute. In Section I, we argue that the countervailing duty law should be applied to reduce impediments to world trade and to preserve the benefits of competition for United States consumers and businesses while protecting firms from unfair practices. In Section II, we argue that not every governmental payment or other benefit conferred on private parties is a countervailable

2 The petition alleges that, in addition to stumpage fee and reforestation subsidies, there are a variety of other subsidies to the Canadian timber industry. For example, petitioners allege that the Canadian federal and provincial governments subsidize their timber industry by purchasing equity rights, providing grants and low-interest or interest-free loans to lumber producers, and providing preferential investment tax credits for the lumber industry. (See Petition, at 88-93). Petitioners allege, in addition, that the Canadian government subsidizes its timber industry by paying for several transportation programs. (See Petition, at 87-88). Moreover, on August 11, 1986, petitioners filed an amendment to their petition alleging the existence of fourteen additional subsidy programs ranging from government funded research projects to preferential freight rates. Given the principal role attributed by the petitioners to the alleged stumpage and reforestation subsidies, we do not consider, in this brief, these other alleged subsidies. The analysis in this brief is limited to the alleged subsidies arising out of: (1) the Canadian provincial stumpage fee system (we refer to these stumpage fee systems as a "system" because they are similar in most significant respects, except where we note to the contrary); and (2) government payments for reforestation.

subsidy, and that countervailing duties should be imposed only on practices that distort trade and alter the operation of comparative advantage.

Section III considers whether the alleged subsidy on stumpage distorts trade patterns and alters the operation of comparative advantage. We examine whether the Canadian stumpage fee system increases the quantity of timber harvested in Canada or the quantity of softwood lumber products exported to the United States. We conclude that, while the Canadian stumpage fee system may increase the profits of Canadian lumber firms, it does not result in more timber being harvested in Canada than would occur if an efficient auction system was used instead of the current system. This is because the quantity of timber available from government land is administratively determined. As a result, the price paid for logs by sawmills does not fall and the quantity of lumber products exported to the United States does not rise due to the stumpage system. We further note that if the Canadian system results in more timber being harvested than occurs under the type of auction employed by the United States Forest Service, it is because of inefficiencies in the Forest Service auction system, and these should not provide the basis for countervailing duties. Accordingly, we conclude that the Canadian system of allocating and charging for the rights to cut timber land is not trade distorting within the meaning of the countervailing duty law and should not be treated as a countervailable subsidy.

In Section IV, we suggest that in evaluating whether the reforestation practices of the Canadian federal and provincial governments provide a subsidy to the Canadian softwood lumber industry, it is necessary to compare the reforestation expenditures of the Canadian governments with the expenditures that would be made by a private owner of the same land. In addition, we suggest that before concluding that any current reforestation grants provided by the Canadian governments are countervailable, it must be demonstrated that these grants are increasing current timber harvests.

ARGUMENT

I. A Major Purpose of the Countervailing Duty Law Is To Promote Free Trade to the Benefit of United States Consumers and Businesses.

In passing the Trade Act of 1974 ("1974 Act"),³ Congress was mindful of the potentially adverse effects on United States business of retaliatory tariffs imposed by foreign governments on United States exports. It determined that "barriers to (and other distortions of) international trade" were adversely affecting United States exports and authorized the President to negotiate international agreements to harmonize, reduce, or eliminate the barriers and distortions. 19 U.S.C. § 2112(a). Congress thus intended the 1974 Act "to expand opportunities for the commerce of the United States in international trade" by improving the rules of international trade. 19 U.S.C. § 2502. The United States subsequently negotiated, as part of the Tokyo

3 Pub. L. No. 93-618, 88 Stat. 1978 (1974).

Round of Multilateral Trade Negotiations, the Agreement on Interpretation and Application of Articles VI, XVI, and XXIII of the General Agreement on Tariffs and Trade ("Countervailing Duty Agreement"). As part of this negotiation, the United States agreed to make it more difficult to impose countervailing duties by adding the requirement that such duties will be imposed only if a domestic industry is injured by reason of the subsidized imports.

The countervailing duty provisions in the Trade Agreements Act of 1979 ("1979 Act"),⁴ which govern this proceeding, had the specific purpose of implementing "the international agreements relating to new disciplines on trade distorting subsidies and dumping practices and procedures for taking countervailing and antidumping measures."⁵ In passing the 1979 Act, Congress foresaw benefits to United States exports if the agreements the 1979 Act implemented were fairly carried out:

These rules could be important in reducing the number of foreign subsidy practices, and thus the need for countervailing duties. Furthermore, if vigorously enforced by the United States and fairly carried out by all parties, these provisions should expand the competitive opportunities of U.S. exporters who currently face subsidized competition in foreign markets.⁶

4 Pub. L. No. 96-39, 93 Stat. 144 (1979); see 19 U.S.C. §§ 1671-1677g, 2501 et. seq.

5 H.R. Rep. No. 317, 96th Cong., 1st Sess. at 2 (1979) ("H.R. Rep. No. 96-317").

6 S. Rep. No. 249, 96th Cong., 1st Sess. at 38 (1979) ("S. Rep. No. 96-249") (emphasis added).

Both the language and legislative history of the 1979 Act confirm that Congress did not intend the countervailing duty laws to be narrowly protectionist. Rather, the purposes of the 1979 Act are "to foster the growth and maintenance of an open world trading system; to expand opportunities for the commerce of the United States in international trade; and to improve the rules of international trade and to provide for the enforcement of such rules." 19 U.S.C. § 2502(2), (3), (4).⁷

Congress realized in 1979 that, because of the precedential value of countervailing duty decisions by this country, such decisions could themselves have a significant impact on United States exports. If the Department finds that a practice of a foreign government is a subsidy, and if comparable practices exist in the United States, our exports may be impaired because of retaliatory countervailing duties based on our precedent. This potential impairment of the export sector of the United States economy is relevant in determining whether Congress intended particular foreign practices to lead to the imposition of countervailing duties on imported goods.

In sum, Congress has sought through the countervailing duty laws to discipline only those firms that are selling in the United States market on the basis of an unfair advantage conferred upon them by their government (or by other sources). Congress intended United States consumers to receive the substantial benefits that flow from unrestricted access to

⁷ See also S. Rep. No. 96-249, supra, at 31; H.R. Rep. No. 96-317, supra, at 38.

foreign firms that compete in United States markets on the basis of comparative advantage or relative efficiency. We suggest that in administering the countervailing duty law, the Department should be guided by the legislative purpose of promoting and maintaining free trade among nations to the greatest possible extent.

II. Congress Intended That Countervailing Duties Be Imposed Only When the Alleged Foreign Subsidy Produces an Unfair Distortion of Trade and Provides an Unfair Competitive Advantage to Canadian Producers.

We examine, in this section, the language, legislative history, and judicial interpretation of the countervailing duty statute to discern Congress's intent concerning the type of governmental practices or programs that should be characterized as a subsidy justifying a countervailing duty. We conclude that Congress intended that countervailing duties should be imposed only to offset an unfair competitive advantage that causes a distortion of international trade. Sound economic analysis can help determine which governmental practices or programs create such trade distortions and thereby alter the operation of comparative advantage.

A. Statutory Language.

Section 303 of the Tariff Act of 1930, as amended, 19 U.S.C. § 1303, provides for the imposition of countervailing duties in the "net amount of such bounty or grant" paid or bestowed on "the manufacture or production or export" of any imported product. In discussing the statutory purpose of this provision, the Supreme Court explained that "[t]he countervailing duty was intended to offset the unfair competitive advantage that foreign producers

would otherwise enjoy from export subsidies paid by their governments." Zenith Radio Corp. v. United States, 437 U.S. 443, 455-56 (1978) (citations omitted) (emphasis added). When Congress enacted the 1979 Act, which applies to this proceeding, it endorsed then-existing countervailing duty law by expressly providing in the new legislation that "the term 'subsidy' has the same meaning as the term 'bounty or grant' as that term is used in section 1303" of the 1930 Act. Trade Agreements Act of 1979, § 771(5), as amended, 19 U.S.C. § 1677(5).⁸ It is now well settled that the 1979 Act incorporated previous countervailing duty law. Cabot Corp. v. United States, 620 F. Supp. 722, 730 (C.I.T. 1985), appeal dismissed, 788 F.2d 1539 (Fed. Cir. 1986) ("same analysis applies regardless of which statute controls, and the law defining the term bounty or grant informs the interpretation of the term subsidy"); Bethlehem Steel Corp. v. United States, 590 F. Supp. 1237, 1240 (C.I.T. 1984) ("primary purpose of the definition of subsidy in section 771(5) ... is to make it plain that the term 'subsidy' has the same meaning as the term 'bounty or grant' and that there is a complete harmony and continuity between the two provisions").

B. Legislative History.

The legislative history of the countervailing duty statute confirms that the purpose of the countervailing duty law is to compensate for an unfair competitive advantage that causes a distortion of trade. In discussing the 1979 Act, the House Ways

⁸ Congress was aware of the Supreme Court decision in Zenith. H.R. Rep. No. 96-317, supra, at 21.

and Means Committee was concerned about "the use of practices which can distort trade or create unfair competition or trade discrimination, such as subsidies."⁹ The committee echoed the Supreme Court's emphasis in Zenith on "competitive advantage," reporting that the statute is intended to provide "greater discipline over the use of foreign subsidies that confer unfair competitive advantages upon the products of the subsidizing country."¹⁰

The congressional debates also provide support for the view that Congress' concern was limited to those foreign practices that distort trade and provide unfair competitive advantages. At the outset of a colloquy with Senator Ribicoff concerning the amendments to the countervailing duty statute, Senator Heinz, who was a leader in supporting the 1979 statutory amendments, stated:

We have an international economy and cannot wall ourselves off from it. Nor should we want to -- for trade invariably means jobs and profits for Americans.

At the same time, however, in our pursuit of trade expansion, we should not abandon our free market principles and our reliance on competition and the law of comparative advantage as arbiters of the marketplace . . .
..

9 H.R. Rep. No. 96-317, supra, at 11 (emphasis added).

10 Id. at 43 (emphasis added); cf. S. Rep. No. 96-249, supra, at 37 (Senate Finance Committee stated that "[s]ubsidies are bounties or grants bestowed (usually by governments) on the production, manufacture or export of products, often with the effect of providing some competitive advantages in relation to products of another country") (emphasis added).

11 125 Cong. Rec. S.10,306 (daily ed. July 23, 1979).

After describing the abandonment by other countries of free-market principles and reliance on competition, Senator Heinz continued:

It is precisely these unfair and, from the standpoint of classical economic theory, trade-restricting practices I seek to control¹²

In the same debates, Senator Danforth explained that the countervailing duty and antidumping provisions were aimed at "adverse distortions of free trade."¹³

C. Judicial Interpretation.

The Court of International Trade repeatedly has recognized the principle that the countervailing duty law is aimed at practices that alter a country's comparative advantage and distort international trade flows by promoting export activity in the country conferring a subsidy. In British Steel Corp. v. United States, the Court of International Trade explained that "the countervailing duty law concerns itself not with the government's purpose or intent in a particular program, but whether the government's funds give the country's exports an unfair competitive advantage." 605 F. Supp. 286, 294 (C.I.T.

12 Id.

13 Id. at S.10317.

1985 (citations omitted).¹⁴ In Cabot Corp. v. United States, supra, 620 F. Supp. at 729, 732, the court confirmed that a benefit bestowing a "competitive advantage" is the essence of a subsidy. "The determination of whether a bounty or grant has been bestowed must . . . be made upon the facts of each case. Since the enactment of section 1303 courts have recognized that they must examine the actual results or effects of assistance provided by foreign governments and not the purposes or intentions." Id. at 730 (citations omitted). Accord, Continental Steel Corp. v. United States, 614 F. Supp. 548, 553 (C.I.T. 1985), vacated in part and reversed in part sub nom. on other grounds, Georgetown Steel Corp. v. United States, 8 Int'l Trade Rep. Dec. (BNA) 1161 (CAFC Sept. 18, 1986) ("only purpose of the countervailing duty law is to extract the subsidies contained in merchandise entering the commerce of the United States in order to protect domestic industry from their effect"); Bethlehem Steel Corp. v. United States, supra, 590 F. Supp. at 1241 ("fundamental purpose of the countervailing duty law is to provide a special duty to eliminate the advantage an imported

14 While there is dictum in British Steel saying that the countervailing duty law is not designed to eliminate trade distortions, that case involved review of a specific Department finding that British Steel received government funding on terms inconsistent with commercial considerations. When read in context, it is clear that by disavowing a trade distortion theory, the court actually was rejecting the allegations made by British Steel that the government funding actually was alleviating a form of trade distortion and that the "rationality" of the government funding must be considered in determining whether such funding is provided on terms inconsistent with commercial considerations. See id. at 292-93.

product may obtain from forms of assistance termed 'subsidies'); ASG Industries, Inc. v. United States, 467 F. Supp. 1200 (Cust. Ct. 1979) (purpose of the countervailing duty law is "to prevent unequal competition in our markets -- to prevent foreign goods from competing with domestic goods at a lower price than they would otherwise be sold").

D. Petitioner's Allegations.

Perhaps recognizing that trade distortion is integral to a subsidy within the meaning of the countervailing duty law, petitioners have alleged that the Canadian stumpage system has such a trade distorting effect. Petition, at 23, 99-100. In addition, petitioners have conceded that the Department is the appropriate forum in which to address this issue.¹⁵ We therefore urge the Department to consider whether the subsidies alleged by petitioners have the requisite trade distorting effect.

E. Summary.

As we have seen above, the principle that the countervailing duty law is aimed at practices that provide an unfair competitive advantage and distort international trade flows by promoting export activity is securely grounded in the countervailing duty statute, its legislative history, and judicial authority. In order for a governmental practice to confer such benefits that it would constitute a subsidy, the practice must have an effect that

15 Certain Softwood Lumber Products from Canada, Inv. No. 701-TA-274 (Preliminary), Conference Transcript (June 10, 1986), at 23, 72 ("FTC's arguments . . . run to the question of the existence of a subsidy, and would be an issue more properly presented to another agency, the Department of Commerce.")

generates trade distortion -- i.e., a shift in trade flows. It appears that the crux of a countervailable subsidy within the meaning of the 1979 Act, therefore, is that a foreign practice must confer a benefit that makes it profitable for a foreign firm to sell a greater amount of output into the United States market. This view is consistent with sound economic analysis, which holds that a subsidy justifying a countervailing duty must alter the operation of comparative advantage. International trade conducted according to comparative advantage results in the most efficient utilization of resources.

The following section explains that the Canadian stumpage fee system does not confer competitive benefits or distort trade. Accordingly, we suggest that the Canadian system should not be characterized as a subsidy within the meaning of our countervailing duty law.

III. The Absence of an Efficient Auction for Stumpage Rights Is Likely To Have no Effect on the Price or Quantity of Exports of Softwood Lumber Products to the United States.

As discussed above, not every governmental payment or other benefit conferred on private parties is a countervailable subsidy. Rather, only those payments that provide foreign competitors with an unfair competitive advantage and distort trade and resource allocation should be subject to countervailing duties. If an alleged subsidy does not increase the supply of imports at any particular price, then the subsidy will not cause the domestic price of the product or the output of the domestic

industry to be lower than they would otherwise have been.¹⁶ As a result, there will be no diminution in the competitive position of the United States industry.

Economic analysis suggests that the system the Canadian provincial governments use to allocate and set the price of stumpage rights -- the Canadian stumpage fees -- does not result in more Canadian lumber being produced or imported into the United States than would occur if the Canadian governments used an efficient competitive auction system with a lump-sum payment scheme. The Canadian stumpage fee system therefore does not provide Canadian firms with an unfair competitive advantage or distort trade patterns. This is because the quantity of timber on public lands in Canada that is put up for harvest each year is set by a government decision, just as it is in the United States. It is not determined by market forces and, therefore, does not depend upon the amount of timber that might be profitably harvested at a particular stumpage fee.

While the Canadian stumpage fee system does not result in more timber being harvested than would an efficient auction system, it may result in more cutting than under the variant of an auction system employed by the United States Forest Service. However, if this occurs, it is because of the inefficiencies involved in the auction system operated by the Forest Service.

16 The imported and domestic products will sell in the domestic market at a single price determined by total supply (imports plus domestic output) and domestic demand. Domestic supply and domestic demand are not affected by a foreign governmental payment. Therefore, if the supply of imports is not increased, the domestic price must be unchanged.

The correct way to solve this problem, if it exists, is to improve the auction system as it operates in this country, not to countervail against the Canadian industry because it operates in a more efficient system.

Below we provide a more detailed discussion of this analysis, which leads us to conclude that the Canadian stumpage fee system does not constitute a subsidy that should be countervailable under United States trade law.

A. The Canadian Stumpage Fee System Does Not Increase Canadian Timber Production.

The Canadian stumpage fee system does not result in more Canadian lumber being imported into the United States than if the Canadian governments used an efficient competitive auction. This is true because the stumpage fee system does not increase the quantity of logs harvested in Canada.

In general, the quantity of logs harvested is the same under the current Canadian system as it would be if an efficient competitive auction were employed.¹⁷ An efficient competitive auction would provide that the payment for harvesting rights is a lump-sum payment independent of the quantity of timber actually

¹⁷ This will be true provided that, under the Canadian stumpage fee system, the logging firm makes a lump-sum payment for the right to harvest a tract of timber land that does not depend on the quantity of timber actually removed from the forest. As discussed in the Appendix at pp. 12-14, if the Canadian system charges for stumpage on a per-unit basis, this can reduce the quantity of timber harvested below that which would be harvested using an efficient auction system.

removed from the forest.¹⁸ Such an auction is efficient because it creates incentives for the owner of the harvesting rights to cut all of the timber on that tract for which the price exceeds the cost of harvesting. Since the government has decided to make a tract available for harvesting, it presumably has determined that it wishes the economical timber on that tract harvested.¹⁹ As a result, a system that causes all timber that can economically be harvested to be taken from the tract is presumably best able to satisfy the government's goal in managing its timber resources.

Although the price charged for the right to harvest a tract of forest land may be lower under the Canadian stumpage fee system, a Canadian logger's ability to harvest more land is limited by the supply made available by the Canadian governments. When the amount of land made available by the Canadian governments is determined without regard to the price charged for cutting on public land, the number of trees cut is independent of that price, and a price lower than the market value of stumpage rights will not result in additional harvesting.

18 The lump-sum payment would not need to all be made at a single point in time. Rather, the key feature of the payment scheme is that the size of the payment must be determined prior to the beginning of harvesting and must not depend on the quantity of timber actually removed.

19 Under the fixed-payment auction system, the logger will remove all timber for which the price is greater than the marginal private cost of harvesting and transporting the timber to the market. The marginal private cost will not include lump-sum payments to the landowner for the stumpage rights, and, hence, the marginal private cost will equal the marginal social cost, assuming that any timber that would be left unharvested on a harvested tract has no social value.

The Canadian governments determine the amount of land to be harvested and then use the stumpage fee system to allocate the land and to collect stumpage fees.²⁰ This governmental limitation on the available land for timber harvesting is not unlike the system in the United States.²¹ Here, the USFS determines what land should be cut and then holds competitive auctions to allocate the stumpage rights and to determine the stumpage fees. Because the land to be harvested is determined by an administrative process, the quantity will not vary with the system used to allocate the lands to specific purchasers or with the price paid under that system. All of the land made available

20 If the Canadian loggers could get as much timber land as they desired at a below-market government rate, they would not be willing to purchase other timber at higher prices. However, petitioners cite evidence that Canadian mills located in Quebec purchase stumpage in Maine for several times the price of government stumpage in Quebec. Similarly they cite claims that stumpage on private lands in British Columbia sells for considerably more than the price of provincial stumpage. See Petition, at 63-65.

21 As Ken Drushka states in chapter 5 of his book Stumped, which is included as Exhibit 8 of the Petition, "our forests both in B.C. and the U.S. are administered by the name of 'even-flow sustained yield.'" (As quoted in the Congressional Record (October 10, 1985), p. S13031, column 2). "Sustained yield policies further compromise the free market. Restricting yearly harvests to an allowable cut in a particular sustained yield unit means that there is a point above which the supply cannot be increased no matter what price buyers are willing to pay." Id. See also Western Transition (Economic Council on Canada, 1984), at 47-49 (hereinafter "Western Transition").

will be harvested under either system.²² Thus, the total quantity of logs going to market in any period is, in general, unaffected by the stumpage fee system employed.²³

B. Because the Canadian Stumpage System Does Not Increase Canadian Timber Production, it Does Not Increase Lumber Exports to the United States and Does Not Affect the Price of Lumber in the United States.

Since the quantity of timber harvested is unaffected because the Canadian governments use their stumpage fee system rather than an efficient auction, use of the Canadian system rather than an auction will not affect the quantity of finished lumber that is exported to the United States. First, sawmills will pay a price for logs that is determined by their demand for logs²⁴ and by the supply of logs from both government and private land. Because the quantity of logs being harvested is not increased as

22 In order for this to be strictly true, the revenue that can be realized by selling the logs on any tract must be greater than the costs of building any roads needed to gain access to the timber, the costs of actually cutting the trees, and the costs of transporting the logs to market. If, for some tracts made available by the government, the costs of logging exceed the revenues that can be earned by selling the timber on the tract, these tracts will not be harvested under either a competitive auction or under the Canadian stumpage fee system. As is explained in the Appendix at pp. 4-7, not all tracts may be cut in this more general case. However, all tracts that would be cut under the Canadian stumpage system would also be cut under a competitive auction system.

23 For three reasons discussed in more detail in the Appendix at pp. 10-14, the quantity of logs harvested in Canada might even increase if the Canadian provincial governments were to adopt an auction system for allocating stumpage rights.

24 The demand for logs is a derived demand which depends on the demand for the lumber and other products that can be made from the logs.

a result of the Canadian stumpage fee system, the price that sawmills must pay for logs is not reduced. The fact that loggers are permitted to harvest a tract of timber land at an advantageous price does not affect the market price at which those logs are later resold. 25

Further, without a change in the price paid for logs, the costs of the sawmill will not change as a result of the stumpage fee system. Therefore, the quantity and price of lumber produced in Canada are the same as if the Canadians employed a competitive auction system for stumpage.

Because the price and quantity of lumber is not affected by the stumpage fee system, the quantity of lumber Canadian firms will choose to export to the United States, and the price they will charge for that lumber, will not be altered by the system. The choice between selling for export and selling for use within Canada will depend on the prices that can be obtained by selling in each country, and this in turn will depend on the demand for

25 The price also would not be affected when a vertically integrated firm uses a log it has harvested. In using such a log, the firms would incur an opportunity cost equal to the price it would have received if it sold the log to another sawmill. It would not make sense for the firm to put a log to an inefficient internal use when it could sell the log for a greater amount on the open market. The sawmill's production of lumber will be the same as if it was purchasing all of its logs from independent logging firms. The International Trade Commission made a similar observation in Conditions Relating to the Importation of Softwood Lumber into the United States, Inv. No. 332-210, USITC Publication 1765 (Oct. 1985) at 80.

and supply of lumber in each country. These demand and supply functions do not depend on the stumpage fee system employed.

C. The Effect of the Low Stumpage Fee Is Merely To Increase the Profits of Canadian Loggers.

If the low stumpage fee does not influence the quantity of logs produced, what effects does it have? The answer is that it merely reduces the total costs and increases the profits of Canadian loggers. In effect, Canadian logging firms are permitted to realize part of the economic rents resulting from harvesting timber.²⁶ If the harvesting rights were sold under a competitive auction, these rents would go to the government in the form of increased stumpage fee payments.

The petition itself contains information suggesting that the low stumpage fees are resulting in high profits for the Canadian logging firms rather than in an increase in the quantity of logs harvested or in a decline in the price of logs. Petitioners report that firms located in Quebec are purchasing Maine stumpage rights at an average price of \$60.33 per thousand board feet at

26 As is explained in the Appendix at pp. 4-5 the payment to the government is an economic rent, and not a cost. The total economic rent resulting from the harvesting of a tract of timber land is the difference between the price for which the logs on the tract can be sold and the cost, not including a payment to the government, incurred in harvesting the logs and transporting them to market. This rent is the maximum a logger would pay for the right to harvest a tract of timber. In a competitive auction system, such as that in the United States, this rent would accrue to the government. If the stumpage fee system in Canada results in payments less than those generated by an auction, a portion of the rent would be captured by the logging firms. However, rather than being retained by the firms as increased profits, it could be dissipated by rent-seeking behavior. See Appendix at pp. 14-15.

the same time that the charge for harvesting timber located on government lands in Quebec was only \$11.96 per thousand board feet.²⁷ Similarly, the petitioners also refer to considerably higher prices being paid for timber on private lands in British Columbia than is paid for stumpage on public lands.²⁸ A profit-maximizing firm would buy stumpage from private landowners or from landowners in the United States at prices that exceed those charged under the Canadian stumpage fee system only if it cannot obtain additional timber at the lower price charged for harvesting timber on government land and if the prices for which the more costly logs can be sold are sufficient to cover their costs. That Canadian firms do purchase this higher priced stumpage is evidence that the prices charged under the Canadian stumpage fee system are well below market prices; that the Canadian governments do not capture all of the economic rents in the sale of stumpage rights; and, hence, that the rents not captured by the stumpage fees must be appearing as increased profits for those firms given access to government forest land.²⁹

Additional evidence that the low stumpage fees under the Canadian stumpage system are resulting in increased profits can be found in the prices Canadian logging firms pay to acquire the future cutting rights of other logging concerns. If the firms

27 See Petition, at 63-64.

28 See Petition, at 65-66 and exhibits 26 and 27.

29 This analysis assumes that the average yields and costs of harvesting timber on government lands are not significantly different than those for private land.

acquiring such rights expected the price at which they would sell the harvested timber to just cover the costs of harvesting plus the payment for stumpage rights, they would not pay anything for the future stumpage rights. However,

[a] survey conducted in early 1981 concluded that the usual price paid for [future harvesting rights] in British Columbia over the previous couple of years ranged from \$25 per m³ . . . in the Interior to \$30 per m³ . . . on the coast.³⁰

That logging firms are willing to pay these amounts to acquire future harvesting rights is evidence that they expect to obtain substantial profits when they cut the timber.³¹

D. The Profits Earned by Canadian Loggers as a Result of the Canadian Stumpage Fee System Do Not Provide an Unfair Competitive Advantage as Might a Subsidy.

The high profits earned by Canadian loggers under the stumpage system do not have the same trade distorting effects as a subsidy granted on either timber or lumber production, contrary to petitioner's claim, at page 24 of the petition, that the Canadian stumpage system is no different from a system in which a competitive price is charged for stumpage and then a subsidy of so much per log harvested is granted.

30 Ken Drushka, Stumped, as quoted in the Congressional Record (October 10, 1985), p. S13032, column 2 (Exhibit 8 of the Petition).

31 Technically, the payments are equal to the discounted future value of the anticipated profit stream that will be generated by cutting the timber for which the harvesting rights are being purchased.

In order to analyze this contention, it is useful to examine a slightly more complicated situation than we have considered previously. Up to now, we have assumed that all tracts of timber offered by the government are logged. That is, we have assumed that the revenue for which the logs on each tract can be sold is greater than the costs of harvesting those logs -- not including any economic rent paid to the government. However, for some tracts made available by the government, the revenue from selling the logs may be less than the cost of cutting and transporting them. This may be true, for example, because of the location or accessibility of the tract. These tracts would remain unharvested whether the tracts are offered under an efficient competitive auction system or under the Canadian stumpage fee system.³²

However, if the government offered a payment for each log harvested, it might become profitable to harvest some tracts that would not otherwise be profitable. With a government payment, it will be profitable to cut any tracts where the revenue from selling the timber plus the payment from the government exceeds the cost of cutting. If some tracts are profitable to cut with the government payment but not without it, then a per unit subsidy will increase the quantity of trees cut. This, in turn, will lead to lower prices for trees and lumber, to a larger quantity of lumber being produced, and to a larger quantity of

32 See the Appendix at pp. 4-7 for a more detailed discussion of this conclusion.

lumber being exported to the United States.³³ Thus, payment of a per unit subsidy can provide foreign firms with an unfair competitive advantage and cause distortions to trading patterns, and hence cause injury to an American industry. However, this is not the way the Canadian stumpage fee system operates.³⁴

E. Use of the Canadian Stumpage Fee System Does Not Have the Same Effect as an Expansion in the Quantity of Timber Made Available for Harvesting by the Canadian Governments.

In attempting to understand the effects of the Canadian stumpage fee system, it is important to differentiate between the effects of the stumpage system and the effects of the decisions of the Canadian governments concerning the quantity of timber

33 See the Appendix at pp. 7-8 for a more detailed presentation of this analysis.

34 There is, in fact, another difference between the current Canadian stumpage fee system and a competitive auction combined with a per unit subsidy. If it is known that the subsidy will be paid before the auction is held, this will cause the competitive bids to be increased to reflect the value of the promised subsidy. As a result, the logging firms will not earn any above normal profits due to the subsidy. Thus, the approach that petitioners depict as being analogous to the current Canadian system would not transfer any economic rents to the logging firms. Rather, all rents would be captured by the government, just as if a competitive auction were held without a subsidy.

that will be permitted to be cut in any period of time.³⁵ While the Canadian stumpage fee system does not provide Canadian lumber firms with an unfair competitive advantage, it is possible that decisions to increase the amount of land made available for harvesting could provide such an unfair advantage. This unfair advantage could occur if the Canadian governments made more land available than would a similarly situated private landowner.³⁶

However, use of the Canadian stumpage fee system does not provide any evidence that the quantity of land made available for harvest by the Canadian governments is greater than a private landowner with the same timber resources would make available. A private landowner would harvest a tract when it is economically

35 In responding to the analysis of the Federal Trade Commission and that of the Canadian respondents in this proceeding, both of which demonstrate that the stumpage fee systems employed by the Canadian governments do not distort trade patterns or create an unfair competitive advantage for Canadian lumber producers, Petitioners confuse the effects of these two separate factors. See Post-Conference Brief on Behalf of Petitioner The U.S. Coalition for Fair Lumber Imports, Before the U.S. International Trade Commission, Investigation No. 731-TA-274 (Preliminary), June 12, 1986, at 43-48.

36 Such an expansion in the quantity of timber harvested would occur unless all of the additional land made available for harvesting was either so expensive to harvest or so lacking in valuable timber that the revenues from sale of the timber on these tracts would be less than the cost of harvesting that timber. See Appendix at p. 10.

efficient to do so.³⁷ There is evidence, however, that the Canadian governments hold timber for a period that exceeds the efficient time frame and allow harvesting "too late" to maximize efficiency.³⁸ This provides evidence that the quantity of timber land that the Canadian governments make available for harvesting is less than the quantity that a similarly situated private landowner would make available.

Even if the Canadian governments were subsidizing their industry by making excessive quantities of timber land available for cutting, the tariff that would countervail against this practice is not equal to the tariff sought by petitioners -- the difference between the price of stumpage rights in the United States and the price that must be paid for stumpage rights to harvest comparable timber under the Canadian system. Rather, the correct countervailing duty would be equal to the amount by which the price that must be paid for the efficient quantity of Canadian lumber imports has been reduced because of the expansion in the supply available.³⁹ Thus, even if the Canadian governments are subsidizing their lumber industry by their decisions concerning the quantity of timber to make available for

37 The private landowner would determine a schedule for harvesting the timber so as to maximize the net present value of the timber resource owned. For a discussion of the economics of timber, see William F. Hyde, Timber Supply, Land Allocation, and Economic Efficiency, Resources for the Future (1980), particularly chapter 3 (hereinafter "Hyde").

38 See Western Transition, *supra*, at 48-51.

39 See the Appendix at p. 16 and especially note 9 for a further discussion of this point.

harvest, the correct solution to this problem is quite different than what is suggested by Petitioners.

F. Inefficiencies in the Auction System
Employed by the United States Forest
Service Should Not Provide the
Justification for Countervailing Duties.

Our analysis to this point has assumed that the auction system to which we are comparing the Canadian stumpage fee system is an efficient one in which a lump-sum payment is required for the right to harvest a tract of timber land. That is, the payment is independent of the quantity of timber actually removed from the forest. Such an efficient auction will maximize the quantity of timber removed from a tract and therefore achieve the government's objectives of getting harvested the timber the government wants to have harvested.

However, there are other ways of organizing the payment for stumpage rights, and some of these may not create incentives for efficient harvesting. For example, if the total stumpage fee that is paid for a tract varies with the quantity of timber actually harvested, firms will have incentives to leave some economical timber in the forest. Instead of removing all timber for which the costs of harvest and transportation are lower than the revenue received when the timber is sold, loggers will want to harvest only those trees for which the revenue from sale would be greater than the costs of harvest and transportation plus the

incremental payment to the government for stumpage rights.⁴⁰

Since the government presumably wishes all of the timber on the tract to be cut, this reduction in quantity harvested is undesirable.

To the extent that the auction system employed by the United States Forest Service ("USFS") does not provide for a fixed payment for the right to harvest a particular tract of land, the output from government lands may be inefficiently reduced.⁴¹ Indeed, output could be higher under the Canadian stumpage fee

40 For a discussion of this and other inefficiencies resulting from a stumpage fee payment based on the actual quantity of timber harvested, see Dennis D. Muraoka and Richard B. Watson, "Improving the Efficiency of Federal Timber Sales Procedures," Natural Resources Journal (October 1983), pp. 815-25. The government may, of course, attempt to counteract this incentive by the requirements it includes in the harvesting contract. For example, it may require that all of the timber on the tract be harvested.

41 The USFS attempts to require that all economical timber is harvested by specifying the quantity of timber to be harvested in the timber contract and reserving the right to sue for failure to satisfy the contract. (Telephone conversation with William Ryburn, USFS, September 9, 1986). In addition, the Forest Service has proposed rules that would require payment of the full amount of the bid for the harvesting rights even if cutting does not occur. (See Federal Register, January 17, 1985, pp. 2591-94). However, enactment of these regulations has been postponed. (See Federal Register, October 11, 1985, pp. 41498-501).

system than under the USFS auction system.⁴² However, to the extent that this is true, it is because of the inefficiency of the USFS price scheme rather than because the Canadian stumpage fee system results in excessive harvesting. That is, if the Canadian stumpage fee system results in more cutting than the USFS auction the Canadian system is more efficient in producing the quantity of timber the government wishes harvested.

If the Canadian stumpage fee system results in more harvesting than the USFS auction system because it is a more efficient system, it does not seem to be appropriate to countervail against Canadian lumber imports. Rather, the correct solution to this problem would appear to be alteration in the auction system employed by the Forest Service in order to make it operate more efficiently.⁴³

G. Conclusion: The Canadian Stumpage Fee System Does Not Distort Trading Patterns or Create an Unfair Competitive Advantage.

In conclusion, based on our understanding of the Canadian stumpage fee system, it does not appear that an unfair

42 On tracts for which the per unit payment under the Canadian stumpage fee system is lower than the per unit payment derived from a competitive auction, there will be incentives to cut less timber under the auction system than under the Canadian system. However, if there are tracts on which the per unit payment under a competitive auction is below the minimum price acceptable under the Canadian system, there will be incentives to cut more timber from these tracts under an auction system. Which system produces the greatest quantity of timber will be depend on the relative importance of these two effects.

43 The imposition of countervailing duties on Canadian lumber imports could provide a precedent for countries with inefficient industries to impose duties on exports from United States firms that operate efficiently.

competitive advantage for Canadian lumber producers is created or that trading patterns for lumber between the United States and Canada are distorted by reason of the methods by which the Canadian provincial governments allocate the timber land they have administratively-determined should be harvested or by the fees they charge for the right to harvest timber lands.⁴⁴ An unfair competitive advantage would arise only if the Canadian stumpage fee system resulted in a greater quantity of logs being cut than would be cut under an efficient competitive auction system. However, this does not appear to be the case. We conclude that the Canadian stumpage fee system results in the same level of cutting as would an efficient competitive auction

44 While there is no direct unfair competitive advantage created by the Canadian stumpage fee system, there are two conditions under which the Canadian system could conceivably indirectly cause an increase in the quantity of timber being harvested. They are described in the Appendix, at pp. 14-16. However, these indirect effects do not seem to be what concerns petitioners.

system.⁴⁵ As a result, the quantity of lumber imported into the United States, and the price for which that lumber is sold, is unaffected by the Canadian system and the competitiveness of domestic lumber and logging industries are not adversely affected. Further, to the extent that the output of Canadian forests is higher than it would be under the auction system utilized by the United States Forest Service, this is because the auction system used by the Forest Service is inefficient. This should not be used to justify countervailing duties.

IV. Expenditure of Public Funds on the Reforestation of Government-Owned Timber Land Does Not Necessarily Constitute a Subsidy of the Canadian Lumber Industry.

In addition to alleging that the Canadian stumpage fee system provides a countervailable subsidy to Canadian lumber producers, petitioners also claim that the Canadian federal and provincial governments subsidize their lumber industry by using government funds to pay for the reforestation of timber lands.

Under four- and five-year Forest Resource Development Agreements, the Canadian federal

45 Petitioners briefly allude to a requirement that logging concerns operating under certain versions of the Canadian stumpage fee system cut a minimum quantity of timber each year and within each five year period or lose the right to future harvesting rights. (See Petition, at 44). If, in order to maintain future rights that are expected to be profitable, this requirement is leading logging firms at present to harvest trees where the revenue received from sales is less than the costs of cutting the timber -- not including any payment that must be made to the Canadian government -- this aspect of the Canadian stumpage fee system could be resulting in an unfair distortion of trade and injury to the lumber industry in the United States. We have seen no evidence that such uneconomic cutting is in fact occurring. However, the Department may wish to further investigate this aspect of the Canadian system.

and provincial governments directly finance reforestation on lands that, but for the provision of timber at preferential rates below a fair market value throughout the last decade, would have been reforested with funds from stumpage payments.

Petition, p. 81.

In considering the alleged subsidy involved in government payments for reforestation on government-owned lands, it is necessary to consider whether, as a result of the practice in question, the quantity of Canadian timber being currently harvested is increased. Only if timber output is increased by the practice can there be an increase in the quantity of lumber exported to the United States and a decline in the price of lumber in this country.

A. Government Reforestation Expenditures Should Be Compared with the Expenditures that Would Be Made by a Private Landowner.

The fact that the government is spending its funds to pay for reforestation of government-owned lands is not, in itself, evidence that a subsidy is involved.⁴⁶ The question is whether

46 To the extent that government funds are used to pay for reforestation of privately-owned lands, the proper standard of comparison would be the level of output that would occur if the government did not pay for reforestation. If the government payments result in an increase in the current output from the private forest land, these payments would clearly appear to be a countervailable subsidy. As discussed below, however, it does not appear that an increase in current reforestation efforts will lead to an increase in current output. Thus, it is not clear that a subsidy of reforestation on private lands should be considered to be a currently countervailable subsidy.

output is increased by this particular governmental practice, and this requires a determination of the relevant output for comparison with current output. Since the government owns the land on which the reforestation is being conducted, government reforestation investments increase the future value of government land and national wealth. Spending funds on reforestation currently will increase the quantity and quality of the timber that can be harvested from that land in the future. In this sense, government investment may be likened to the wealth-enhancing investment decision of a private landowner.

This suggests that the proper standard for comparison is the level of investment that would be undertaken by a private landowner.⁴⁷ If the Canadian governments are investing no more in reforestation than would a private landowner, the output of the forest land, now and in the future, will be no greater under government ownership than it would be under private ownership, and therefore no subsidy should be found to exist. Only if the Canadian governments are spending more than would a private owner is it possible that the government is subsidizing its timber industry.

47 So long as there are no external costs or benefits resulting from dedication of land to timber production, private decision-makers will invest in reforestation at a rate that is optimal from society's point of view. Musgrave & Musgrave, Public Finance in Theory & Practice, 6-7 (1973).

B. The Petition Does Not Present Evidence that the Canadian Governments Are Subsidizing Their Lumber Industry Through Reforestation Activities.

The allegations contained in the petition are clearly insufficient to demonstrate that the reforestation expenditures being made by the Canadian governments are inefficient, i.e., are greater than the levels that would be undertaken by a private landowner. In selecting the level of reforestation investment to undertake, the private landowner would maximize the present value of the future proceeds from sale of the rights to harvest the timber on a tract minus the present investment in reforestation.⁴⁸ Consequently, investment in reforestation could exceed revenues realized by the Canadian governments on the sale of the current timber because (1) the real price of timber may be expected to rise in the future,⁴⁹ or (2) the Canadian governments may not be capturing all of the economic rents from timber sales.

48 For a discussion of the conditions for optimal investment in timber, see Hyde, supra, particularly chapter 3. Of course, a private landowner would sell the rights to harvest in such a way that he captured all of the proceeds from sale of the harvesting rights. He would not utilize a system like the Canadian stumpage fee system which allows harvesters to capture a portion of these proceeds. However, even though the Canadian governments do not capture all of the returns to their reforestation investments, their investments will not differ from what a private landowner would undertake, as long as they maximize the social return to their investments in reforestation.

49 The real price of stumpage has risen in North America over the past 150 years and it has been suggested that this trend is likely to continue into the future. See Hyde, supra, at 68. See also the projected future increases in real stumpage prices reported in Christopher D. Risbrudt and Paul V. Ellefson, "An Economic Evaluation of the 1979 Forestry Incentives Program," University of Minnesota Agricultural Experiment Station, Station Bulletin 550 (1983).

Even if the Department were to determine that the Canadian governments were engaging in excessive reforestation, this would not demonstrate that currently imposing a countervailing duty is appropriate. Such a duty would be appropriate only if the actions of the Canadian governments are leading to an increase in

the quantity of timber currently being harvested.⁵⁰ If the reforestation being done by the Canadians is merely increasing future timber harvests, but is not increasing current harvesting, no current unfair competitive advantage is created.

50 If a private landowner is maximizing the net present value of his or her timber resources, a decision to increase his or her reforestation efforts will not lead to an increase in current harvest rates. The additional reforestation is an investment that will yield its return only when the newly planted trees have grown to maturity. Unless the expectation of larger output in the future causes the optimal growing periods to be shortened with the result that more timber is harvested currently, the current level of reforestation will have no effect on current harvests. And, given that it takes many years for trees to grow to maturity, it is likely that any effect of future output levels on optimal current harvests will be very small.

However, if, rather than maximizing the net present value of his timber resources, the landowner practiced some forms of sustained yield management on his or her timber land, an increase in current reforestation could lead to an increase in current harvesting. See Hyde, supra, at 18-19.

Under United States Forest Service regulations, the minimum acceptable payments for stumpage rights on Forest Service lands must be high enough to cover "the cost of regeneration made necessary by the sale." (Forest Service Manual 2421.6 (Oct. 1977) (emphasis added)). This requirement can result in some tracts of land that are made available for harvesting being left uncut, even though the revenues that could be realized by selling the timber on the tract exceeds the cost of harvesting that timber. This would occur with tracts for which the difference between the price at which the timber can be sold and the cost of harvesting the timber is less than the cost of reforestation. While the absence of such a requirement on the part of the Canadian governments may seem to provide their lumber manufacturers with an unfair competitive advantage, the more appropriate conclusion appears to be that United States producers are disadvantaged by the regulation. As we have seen above, a private landowner seeking to maximize the value of the timber on his or her land would not impose such a regulation on himself or herself. While the regulation may be designed to further our nation's objectives in terms of conservation or some other use of timber land, it would not be efficient to require other countries to impose a similar regulation on their timber harvesting operations.

In conclusion, before it can be found that the Canadian governments currently are subsidizing their timber industry through reforestation investments, two facts must be demonstrated. First, it must be demonstrated that the level of reforestation being undertaken is greater than would be done by a private landowner. Second, it must be shown that this increase in current reforestation is leading to an increase in current cutting of timber from government lands.

CONCLUSION

For the reasons stated above, we submit that the Canadian stumpage fee system does not constitute a countervailable subsidy to the Canadian softwood lumber industry. We further suggest

that petitioners have not demonstrated that Canadian government payments for reforestation provide a countervailable subsidy.

Respectfully submitted
on behalf of
the Federal Trade Commission,

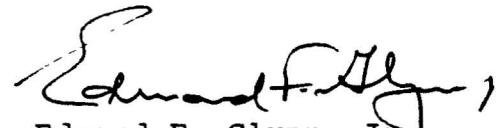
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November 26, 1986

APPENDIX

THE EFFECTS OF THE CANADIAN STUMPAGE FEE SYSTEM
AS COMPARED TO AN EFFICIENT AUCTION SYSTEM

by

Keith B. Anderson¹

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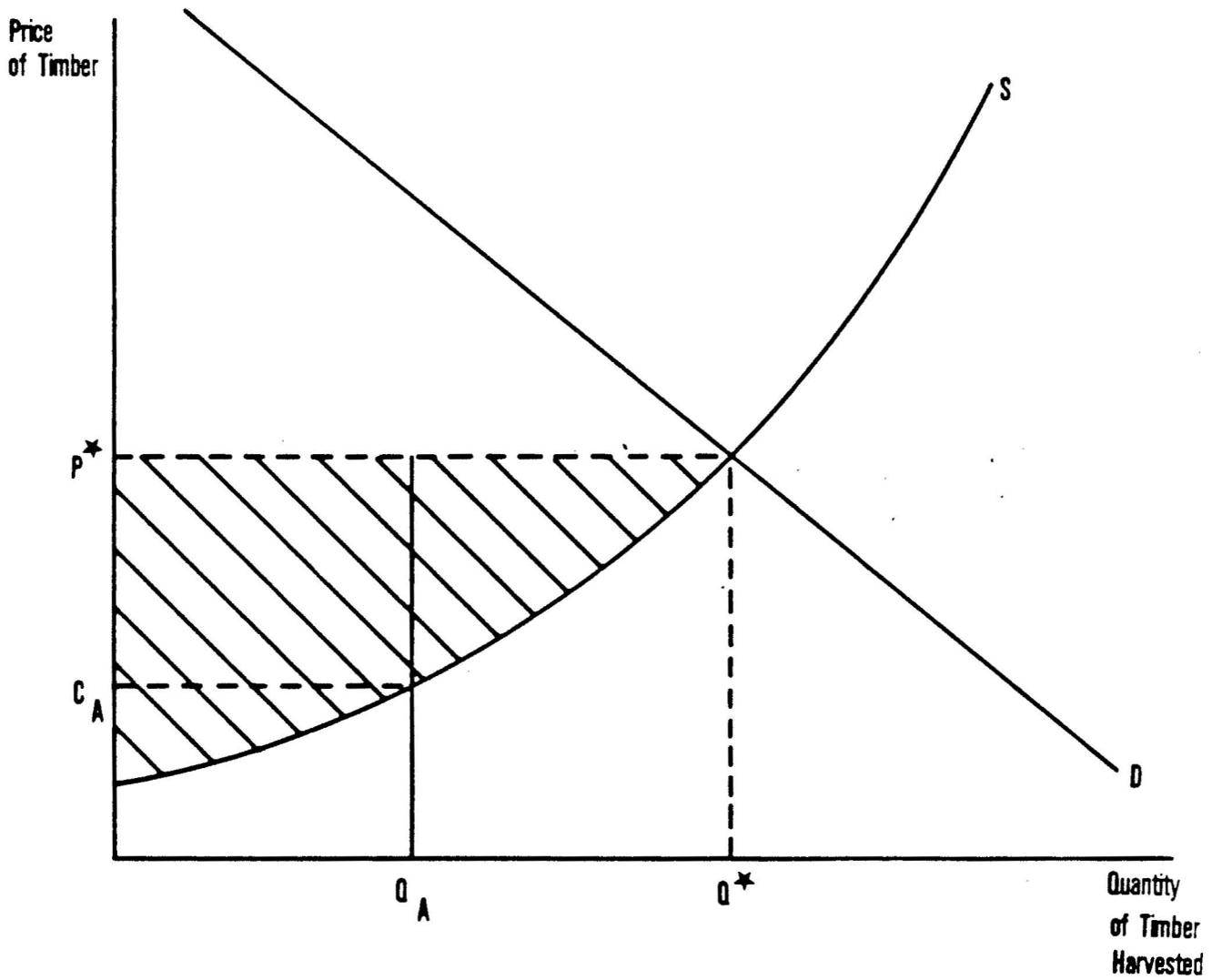
In this appendix we provide a graphical presentation of the workings of an auction system and of the Canadian stumpage fee system. We demonstrate that, in general, the same tracts will be harvested where the Canadian system is used to allocate harvesting rights and to determine the price received for these rights as when an efficient auction is utilized for these purposes.¹ The effects of a true production subsidy are then considered, along with the effects of an uneconomic expansion of the quantity of timber land made available for harvest. We then consider why the Canadian system may actually result in less timber being harvested than if the Canadian governments were to employ an efficient auction system. Finally, while the Canadian stumpage fee system does not directly cause the quantity of timber harvested to be any higher than it would be with an auction system, we consider some hypothetical situations under which the Canadian system may indirectly result in an expansion in the quantity of timber harvested.

A. The Demand for and Supply of Timber

To begin our analysis, consider Figure 1, which shows the demand for and supply of timber. The demand curve (labelled D in Figure 1) shows the quantity of logs that users will purchase at each price. The demand for logs is a function of the demand for the products, such as lumber and paper, that

¹ By an efficient auction system, we mean a system that involves a lump-sum payment for the right to harvest a tract of timber land. Such an auction system is efficient in that it will result in the greatest quantity of the timber the government wishes to be harvested actually being cut.

Figure 1



can be produced from a log. The demand curve slopes downward because as the quantity of logs harvested expands, the quantity of products produced from those logs expands and the price at which the increased quantity of those products can be sold falls. As a result, firms who use logs to manufacture these other products will purchase more logs only if the price they have to pay declines.

The supply curve of logs (S in Figure 1) represents the price that must be received if a particular quantity of timber is to be harvested. A logger will be willing to harvest an additional unit of timber only if the price he receives is at least as great as the costs he incurs in cutting the timber and transporting it to the sawmill.

The costs of harvesting the trees on a tract do not include, however, any payment to the government for the right to cut the trees. The payment to the government is an economic rent, and not a cost. This is because the availability of the land for harvesting does not depend on the price received by the government. The trees have grown on the tract either naturally or as a result of planting that was done 20 or more years ago. The government has decided that now is the optimal time to cut the trees. Therefore, the trees are available for harvest provided loggers are willing to cut them. The same trees are available if a high price is paid for the harvesting rights as if a lower price is paid. So long as any positive price is paid, the trees will be made available for harvest. This is quite different from the cost the logger must pay for other things such as gasoline. The amount paid for gasoline is a true cost: If the price is not paid, the gasoline will not be made available.

The supply curve slopes upward because, as the quantity of logs harvested increases, the cost of harvesting additional logs increases. Some tracts are more difficult to harvest than others. Also, some tracts are further from the sawmill, and it is therefore more expensive to transport the logs to the mill.² If only a few logs are needed, only those tracts with the lowest cost of harvesting and transportation will be harvested. As the quantity to be harvested increases, tracts that are more expensive to harvest will need to be cut. However, loggers will be willing to do so only if the price they receive is high enough to cover the higher costs incurred.

Once the demand and supply of timber are known, the equilibrium price and quantity can be determined. The equilibrium occurs at the intersection of the supply and demand curves. In Figure 1, the equilibrium price is P^* and the equilibrium quantity is Q^* . At any quantity below Q^* , the price buyers would be willing to pay for an additional unit of logs is greater than the cost of cutting them. It is therefore profitable for the logger to supply those logs. At a quantity greater than Q^* , the cost of harvesting the last unit of logs is greater than the price buyers would be willing to pay. Therefore these units are not harvested.

B. The Level of Economic Rents

We can now identify the level of economic rents associated with any tract of land. For example, consider the tract that will produce unit of timber Q_A in Figure 1. Since this unit of timber can be sold for P^* and

² In addition, some tracts may not contain as many trees as others or may contain less valuable species.

since the cost of harvesting the timber -- read off of the supply curve -- is C_A , the rent associated with the harvesting of unit Q_A is P^* minus C_A . For any other unit of timber to the left of Q^* in Figure 1 there is a similar positive economic rent equal to the difference between the price P^* and the cost of producing that unit of timber. For units of timber to the right of Q^* , there is no economic rent because the cost of harvesting the timber is greater than the price for which it could be sold. Thus, the total economic rent from harvesting timber is the shaded area between the supply schedule and the horizontal line at P^* .

C. The Harvesting Decision and the Distribution of the Rents When An Auction Is Employed

Under an efficient auction system, logging firms enter bids for the right to harvest any tract of land offered by the government which they are interested in harvesting. If harvesting a tract will generate a positive economic rent, loggers will be willing to bid on the tract. On such a tract the logger can pay a positive price for the harvesting rights and still not lose money by cutting the timber. However, no firm will bid on any tract where the cost of harvesting is greater than the revenue earned by selling the timber on that tract -- that is, any tract to the right of Q^* in Figure 1. Even if the firm received such a tract as a gift, it would lose money by harvesting the timber on that tract. As a result, under an auction system, bids will be entered on all tracts to the left of Q^* in Figure 1 and this quantity of timber will be cut.

If there is competition for the harvesting rights on various tracts, the competition will cause the price paid to rise to equal the economic rent. As a result, under an auction system, all of the economic rents will be paid to the government in the form of payments for stumpage rights.

D. The Harvesting Decision and the Allocation of Rents Under the Canadian Stumpage Fee System

While there are a number of variants of the Canadian stumpage fee system, the key characteristics of the system appear to be as follows. The rights to harvest a particular tract are determined administratively rather than competitively. That is, through an administrative process, a particular firm is granted the rights to harvest whatever timber is to be cut within a particular area. Also, the price that the firm will pay for the right to harvest this timber is determined by an administrative process. The key claim of petitioners is that this payment is less than the payment that would be made under a competitive auction. That is, while the payment is greater than zero, it is less than the total economic rent generated by harvesting the timber on a particular tract of land. The logging firm is thus able to keep some of the economic rent.

Under a system like that just described, a logging firm will be interested in harvesting any tract of land on which there is a positive economic rent, since the firm is allowed to keep some of that rent. Thus, the firm will earn a positive profit by harvesting such tracts. However, no logging firm will be interested in harvesting any tract on which the costs of harvesting exceed the revenue that can be received by selling the timber. The firm would lose money by harvesting any such tract and will therefore not do so. As a result, all tracts to the left of Q^* in Figure 1 will be

harvested and none of the tracts to the right of Q^* will be harvested. This is the same result as with an auction system. In general, the quantity of timber harvested under a Canadian auction system is the same as the quantity that would be harvested if an efficient auction system were employed.

While a competitive auction system results in the same quantity of timber being cut as the Canadian stumpage system, the two systems do not generate the same distribution of the economic rents resulting from the harvesting of timber. As we have already seen, a competitive auction will result in all of the economic rents being received by the government, i.e., the landowner. Under the Canadian system, however, the logging firms are permitted to keep part of the rents. As a result, the revenues going to the government in the form of stumpage payments are smaller under the Canadian system than with a competitive auction. However, this does not result in any change in the quantity of timber harvested.

E. The Effects of a Per-Unit Subsidy on the Quantity of Timber Harvested

It is useful to compare the effect of the Canadian stumpage fee system on the quantity of timber harvested with the effect of a per-unit production subsidy granted to Canadian loggers. While there is no allegation in the present case that such a subsidy is paid, petitioners assert that use of the Canadian stumpage fee system rather than a competitive auction has the same effect as a per-unit subsidy.

If the Canadian governments were to grant a subsidy per unit of timber harvested, this would cause the supply curve to shift downward by the

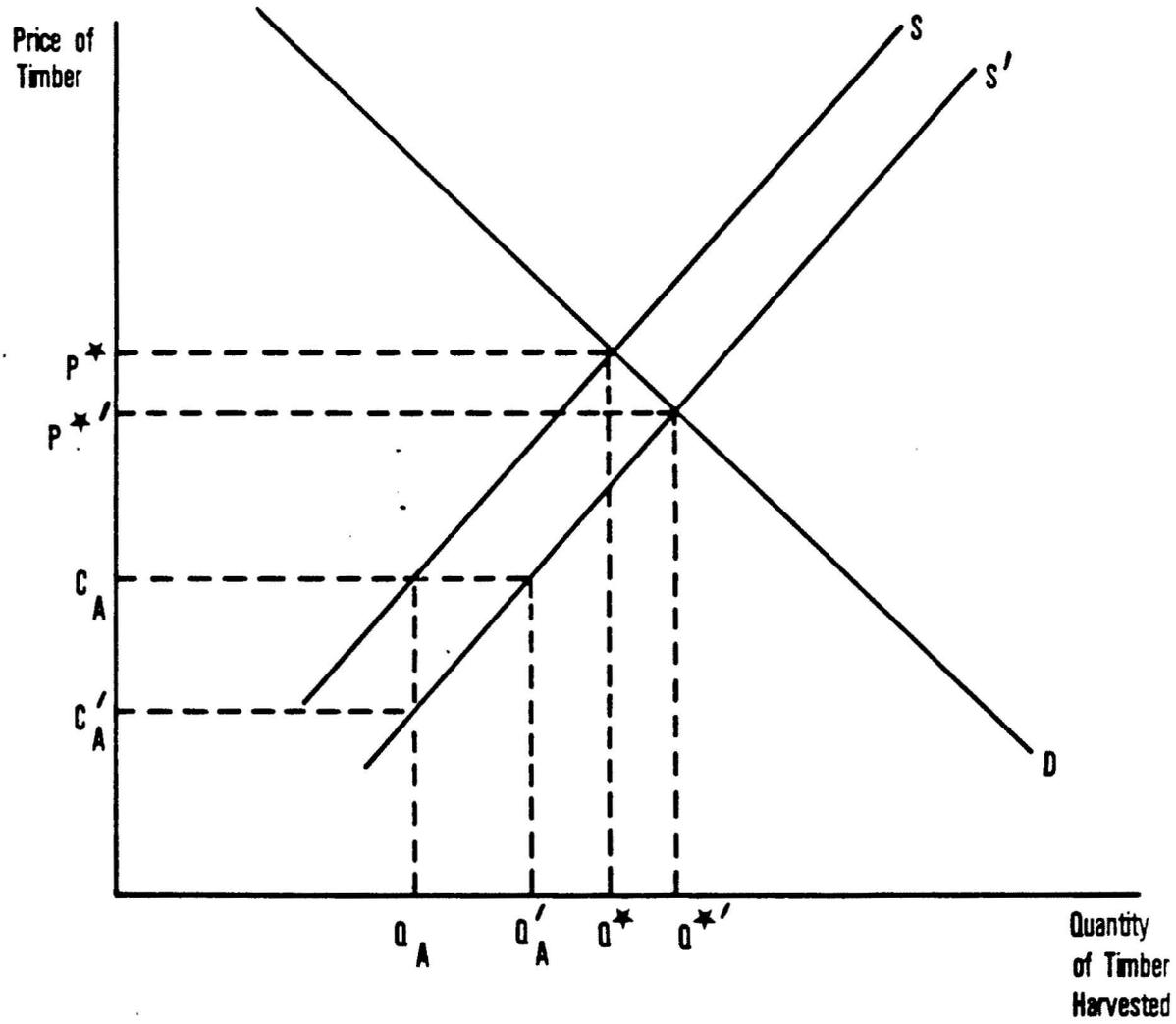
amount of the subsidy. Figure 2 provides an illustration of the effect of such a subsidy. In this figure, it is assumed that the net cost of harvesting tract Q_A becomes C_A' rather than C_A after the subsidy is paid. That is, the subsidy is equal to C_A minus C_A' .

The willingness of the government to pay such a subsidy causes the supply curve to shift downward from S to S' . This occurs because logging firms are now willing to supply timber for a lower price. Instead of being willing to supply a unit of timber only if the price paid is great enough to cover the costs of harvesting, loggers will be willing to supply so long as the price plus the subsidy payment are great enough to cover the costs. Payment of a per-unit subsidy causes the quantity of timber harvested to increase from Q^* to $Q^{*'}$ in Figure 2. In addition the price of timber falls from P^* to $P^{*'}$.

Thus, payment of a per-unit subsidy increases the quantity of timber harvested. While the cost of harvesting units of timber between Q^* and $Q^{*'}$ is greater than the price that purchasers will pay for the timber, the cost is below the price plus the subsidy payment. It is therefore profitable to harvest these tracts when a subsidy is paid.

Therefore, use of the Canadian stumpage fee systems does not have the same effect as the payment of a per-unit production subsidy. A per-unit subsidy shifts the supply curve of timber downward with the result that more timber is harvested and the equilibrium price of timber is lower. The Canadian stumpage fee system, on the other hand, does not expand the quantity harvested, nor does it affect the equilibrium price of timber.

Figure 2



F. The Effects of an Increase in the Supply of Land Made Available for Harvesting

Consider now what would happen if the Canadian governments expanded the quantity of timber land made available for harvest. Again, this is not what petitioners claim is causing problems for the United States lumber industry. However, if as part of such an expansion, the Canadian governments were to make available additional tracts on which the harvesting costs were relatively low, the supply curve would shift outward as more timber is now available for which the harvesting costs are below any particular price. For example, in Figure 2, an increase in the quantity of land made available for harvesting increases the quantity of timber that can be harvested for a cost of C_A from Q_A to Q_A' .

As in the case of a per-unit subsidy, an expansion in the quantity of land made available for harvesting can cause the quantity of timber harvested to expand and the price of timber to fall. This is in contrast to the effect of the Canadian stumpage fee system, which does not cause the quantity to expand.

G. Why the Canadian System May Result in Less Timber Being Harvested

While our general characterization of the Canadian stumpage system led us to conclude that the same quantity of timber will be harvested under the Canadian stumpage system as with an efficient competitive auction, there are several reasons for believing that the Canadian system may actually result in fewer logs being harvested. First, with some versions of the Canadian stumpage fee system, the government establishes a fixed fee for harvesting a

tract rather than having a fee that depends on the economic rent that will be generated by harvesting that tract. In such a case, the government may set the stumpage fee too high and impose a fixed fee that exceeds the economic rent that could be earned by harvesting the tract. Tracts for which this occurs will not be harvested but will remain standing. With a competitive auction system, on the other hand, some firm would enter a bid which is lower than the fee required under the Canadian system but which would make the harvesting of the tract profitable. Thus, under a competitive auction system, the tract would be cut.³

Second, the Canadian stumpage fee system may be more likely than an auction to allocate harvesting rights to inefficient firms.⁴ It may not be profitable for the firm with the harvesting rights to cut a tract, although a more efficient firm would find harvesting profitable. Again, this can result

³ We note that the United States Forest Service also establishes a minimum price in the bidding for harvesting rights on Forest Service lands. This creates the possibility that some tracts will not be harvested under the auction system as applied by the Forest Service. However, in general, the purpose of the minimum price appears to be to insure that the government receives the value of the timber being auctioned and not to limit the quantity of timber being cut. If the minimum bid values are set correctly, there would always be bids that meet the minimum and all of the land made available would be sold. If the USFS systematically overstated the value of the timber on its lands, the quantity of land harvested could be reduced. However, such a situation is not an inherent part of an auction system and would represent a distortion in the United States application of the auction system.

One exception to this general statement is the requirement that minimum bids must be great enough to cover the cost of reforesting the tract being auctioned. See United States Forest Service Manual, Section 2421.6 (October 1977) This can cause some tracts that are made available to go unsold. However, again, this requirement is specific to the auction system used in this country. It is not necessary that an auction system contain such a minimum bid requirement.

⁴ To the extent that an inefficient firm can sell its harvesting rights to other, more efficient firms, this problem would be reduced or eliminated by such sales.

in the cutting of fewer trees.

Third, the Canadian governments are likely to incur administrative expenses in making a tract available for cutting. For example, it may be necessary for the government to survey the tract and to develop a harvesting plan. If the funds available to pay for such administrative expenses depend on the revenues collected from the sale of stumpage rights, the Canadians may be able to prepare fewer sites for harvesting than if a competitive auction raised additional funds.⁵

Finally, the analysis up to this point has implicitly assumed that the fee for logging a tract of timber land is determined before the timber is cut and does not depend on the quantity of timber actually removed from the tract. (The payment would, of course, depend on the purchaser's estimate of the value of the timber located on the tract.) However, this does not appear to be true, at least as regards timber harvested from land owned by the British Columbia provincial government. In a manner methodologically similar to the system used by the United States Forest Service, British Columbia determines the appraised value of a tract of timber land. However, instead of collecting this appraised value in a lump sum amount, British Columbia charges loggers the average appraised value of stumpage for each species on the tract on a per-log harvested basis. That is, the total appraised stumpage value is divided by the quantity of timber on the tract, and the logger pays this average fee for each unit of timber removed. As a

⁵ We have heard reports that the quantity of land offered for cutting on United States Forest Service lands has been reduced below allowable cut levels in some years because the Forest Service has not had sufficient funds to prepare all of the available tracts for marketing. (Telephone conversation with Steve Ruddell, U.S. Forest Service, East Lansing, Michigan, August 14, 1986.)

result, some trees for which the price of the logs would exceed the costs of cutting, and which therefore would be cut under a lump sum scheme, will not be cut. For these logs, the average appraised value is greater than the difference between the log price and the cutting and hauling costs. Because the logging firm would have to pay this average appraised value if it removed these trees from the forest, it is not profitable to remove them.⁶

Similar problems may exist with the versions of the Canadian stumpage system employed in the other provinces where a fixed fee is charged per unit of timber. This would be true if this fixed fee is levied on timber actually removed from the forest rather than on an estimate of the quantity of timber present on a tract which is to be cut. Based on petitioners' description of the stumpage fee systems in Ontario, Quebec, and Alberta, the quantity to which the fixed fee is applied is not clear. However, it appears that the fixed fee may well be collected on the basis of timber actually removed from the forest.⁷

⁶ See Western Transition (Economic Council of Canada, 1984) at 55. We note, however, that the magnitude of this effect would be limited by requirements that loggers cut a certain percentage of the allowable cut in any year and within any five year period.

⁷ See Petition, at 45-48. We note that similar problems may exist with the auction system as it is employed by the United States Forest Service. That is, rather than operate an efficient auction system where the payment for the stumpage rights to a tract of timber land do not vary with the quantity of timber actually removed, the USFS apparently collects stumpage payments by collecting a certain amount per board foot of timber removed. The inefficiency of this practice was noted in Dennis D. Muraoka and Richard B. Watson, "Improving the Efficiency of Federal Timber Sales Procedures," Natural Resources Journal, 23 (October 1983), pp. 815-25. There have been proposals to alter the payment scheme for Forest Service auctions in ways that would eliminate these inefficiencies. See Federal Register, January 17, 1985, pp. 2591-2594 and Dennis D. Muraoka and Richard B. Watson, "Improving the Efficiency of Federal Timber Sale Procedures: An Update," Natural Resources Journal, 26 (Winter 1986), pp. 69-76. However, these proposals have yet to be implemented. See Federal Register, October 11, 1985, pp. 41498-41501.

Thus, given the quantity of timber land made available for harvest by the Canadian provincial governments, less timber may be harvested if the Canadian stumpage fee system is used to allocate the harvesting rights and to determine the fees the government receives for those harvesting rights than if a lump-sum fee determined by a competitive auction were used. Rather than increasing the quantity of timber harvested and thereby creating an unfair competitive advantage for the Canadian lumber industry, the Canadian system may, in fact, reduce the output of the Canadian lumber industry and thereby reduce the quantity of exports to the United States.

H. Conditions Under Which the Canadian Stumpage Fee System Could Lead to an Increase in the Quantity of Timber Harvested

While there is no direct unfair competitive advantage created by the Canadian stumpage fee systems, there are two conditions under which the Canadian fee systems could conceivably indirectly cause an increase in the quantity of timber being harvested. First, the Canadian stumpage fee systems could lead to an increase in the quantity of Canadian timber harvested if the timber companies successfully lobbied the Canadian federal or provincial governments to expand the quantity of cutting permitted because of the increased economic rents they would earn by cutting additional trees at the low stumpage fee.

At least one of the petitioners' exhibits suggests that this kind of behavior has occurred in the past. According to Peter Griffiths,

"[M]any mills overbuilt their capacity in relation to the actual timber supply, as a means of consolidating their domination of the resource. The British Columbia Forest Service was forced to exceed allowable cuts under pressure from politicians afraid of mill closures and lost jobs in their constituencies." (Equity, April 1984, as contained in exhibit 12 to the Petition)

This statement, if true, could imply that the low stumpage fees have, at least in the past, resulted in an increase in the quantity of timber harvested. Such behavior would not be profitable under a competitive auction system where loggers earn only a normal profit level. Evidence that sawmill capacity is being expanded beyond the level necessary to process current allowable cuts in order to convince Canadian federal or provincial governments to expand the allowable cut could suggest that the low stumpage fee charged by the Canadians could be indirectly injuring the United States timber industry.⁸

The second condition under which the Canadian stumpage fee system could lead to an increase in the quantity of timber harvested is if the Canadian stumpage system reduces the risk that Canadian timber firms will be unable to meet their debt obligations and thereby reduces the price the firms must pay for debt capital. If this were to occur, Canadian loggers might have lower costs than if the Canadian governments were to utilize an auction system and, as a result, some tracts might be profitable to harvest even though they would not be profitable to harvest under the higher costs Canadian loggers would have with a competitive auction.⁹

⁸ In evaluating claims of this kind of "rent seeking" behavior, it is important to differentiate between building new capacity to justify expansions in cutting and urging that cutting levels be maintained so as to utilize existing capacity and to avoid unemployment. While the former behavior is only rational when the firm can obtain economic rents by cutting timber, the latter is rational even if no return above a normal profit is earned by harvesting timber.

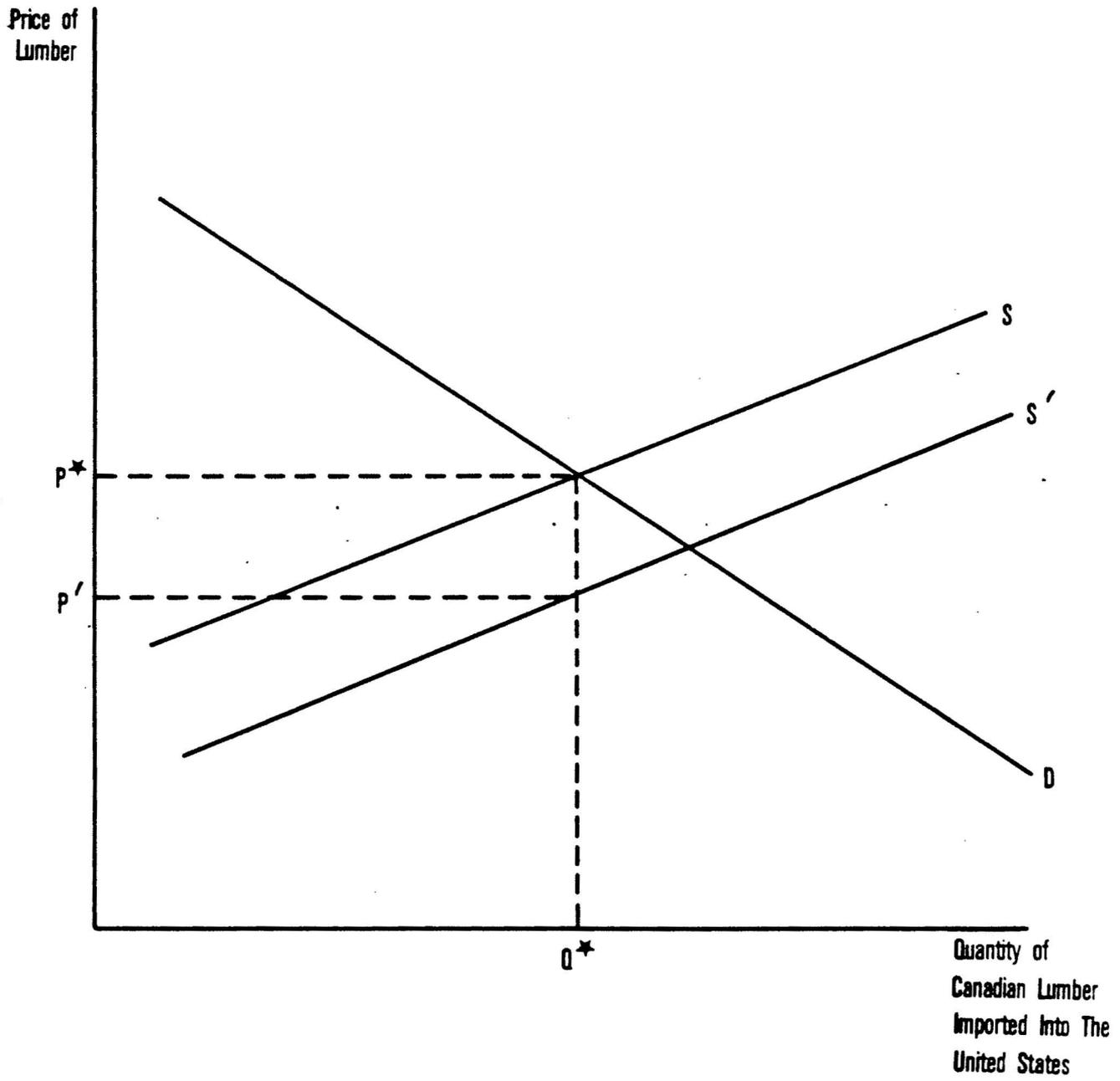
⁹ It should be noted that the higher profits loggers earn as a result of low stumpage fees could be dissipated by rent-seeking behavior. To the extent that this occurs, there would be no reduction in the risk of bankruptcy, and therefore no reduction in capital costs.

We have no evidence that either of these conditions currently exists in the context of the production of lumber by Canadian firms. At this point they are only hypothetical possibilities. However, the Department of Commerce may wish to examine these issues further.

If the quantity of Canadian timber harvested is being expanded by either of these situations, the correct duty to countervail against the unfair competitive advantage obtained by the Canadian lumber industry is not the duty sought by petitioners -- the difference between the price paid for stumpage rights under a competitive auction system in the United States and the price paid under the Canadian stumpage fee systems. Rather, the correct duty would be equal to the amount by which the price that must be paid to bring forth the efficient quantity of Canadian lumber imports has been reduced by the practice.¹⁰ It is likely that this duty would be substantially less than the duty sought by petitioners.

¹⁰ This tariff can be illustrated by referring to Figure 3. The efficient import supply curve -- i.e., the supply curve absent any subsidies -- is S. Therefore, the efficient quantity of imports into this country is Q^* . If, however, subsidies shift the import supply curve to S', the correct duty to countervail against these subsidies is equal to P^* minus P' . Imposing such a duty would cause the equilibrium price and quantity to be equal to their values in the absence of any subsidy. That is, equilibrium price and quantity would be P^* and Q^* respectively.

Figure 3



CERTIFICATE OF SERVICE

I hereby certify that on this 26th day of November 1986, I have served the foregoing Pre-Hearing Brief by causing the original and 20 copies to be hand-delivered to the Deputy Assistant Secretary for Import Administration, Attention: Import Administration, Central Records Unit, and a copy to be mailed first class, postage prepaid to the following:

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