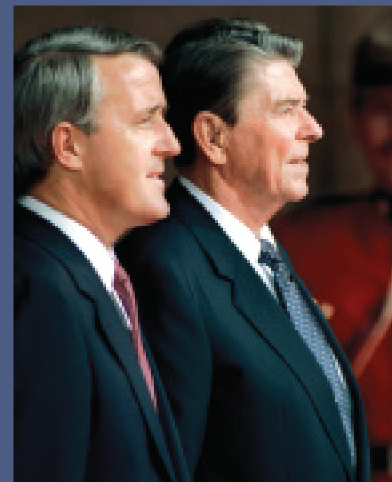
FREE TRADE AND DISPUTE SETTLEMENT: TIME TO DECLARE VICTORY

Michael Hart and Bill Dymond



A key goal in negotiating the Canada-US Free Trade Agreement (FTA) was to replace US antidumping and countervailing duties on Canadian exports with a new set of rules on subsidies and unfair competitive practices. The result was enhanced dispute settlement but not the new rules Canada sought. Did the FTA fail to solve the problem? Antidumping and countervailing duties have virtually disappeared from use. Softwood lumber is the exception that proves the point. The record of the past 20 years suggests that the FTA largely solved the problem, but on a different basis that few could have foreseen.

La négociation de l'Accord de libre-échange entre le Canada et les États-Unis visait notamment à remplacer les droits antidumping et compensateurs américains sur les exportations canadiennes par un nouvel ensemble de règles sur les subventions et les pratiques concurrentielles déloyales. Le Canada a obtenu un processus de règlement des conflits amélioré mais pas les nouvelles règles qu'il réclamait. Pour autant, l'Accord a-t-il échoué à ce chapitre ? Les droits antidumping et compensateurs ne sont pratiquement plus appliqués, sauf dans le cas du bois d'œuvre, une exception qui en confirme la quasi-disparition. En fait, le bilan des 20 dernières années montre que le libre-échange a permis de résoudre l'essentiel du problème, mais sur d'autres bases que prévu.

Twenty years ago, one of the key goals in negotiating the Canada-US Free Trade Agreement (FTA) was to address the problem of trade remedies. Canadian industry had become increasingly vulnerable to the application of antidumping and countervailing duties inspired by their US competitors and argued that any free-trade agreement between Canada and the United States needed to include a solution to this problem. In public discussion, the answer appeared to be gaining exemption from the application of US trade remedies to Canadian exports. The reality was a little more complicated. Canada sought a replacement regime that would rely on cross-border disciplines on subsidies and unfair price competition, backed up by dispute settlement procedures. In the event, Canada's proposals did not prove negotiable. Instead, the two teams worked out a new set of rules centred on binational oversight of the application of trade remedies. To critics of the FTA, this second-best solution became central to their case that Canada had failed to achieve a balanced agreement that responded to Canadian priorities.

The experience of the past 20 years offers some interesting insight on how to assess the strengths and weaknesses of the FTA, including its treatment of the trade remedy issue. It is certainly true that Canada settled for less than it sought when it agreed to live with the binational review procedures set out in Chapter 19 rather than the more ambitious goals with which we started. But did the FTA fail to solve the trade remedy problem? The record of the past 20 years suggests that it largely did, but on a different basis than was originally sought.

Canada and the United States can both lay claim to having invented trade remedies. Canada added antidumping duties to its trade policy toolbox in 1904 in an effort to curb the practice of large US firms dumping excess production in Canada at lower than US domestic prices. The United States first introduced countervailing duties in 1890 to offset the ability of foreign sugar producers to evade the impact of the US tariff by paying a bounty or subsidy on exports to the US market; Congress extended this remedy to all dutiable US imports in 1897. The United States introduced its own antidumping procedures in 1916, while Canada did not add the ability to impose countervailing duties to its arsenal until 1977.

Neither remedy was much used in the opening years of the twentieth century, but antidumping in particular came

into its own as part of the protectionist backlash to the problems of the depression of the 1930s. Its prevalence was sufficient to ensure that both Canada and the United States insisted that the 1947 General Agreement on Tariffs and Trade (GATT) provide for this remedy, as well as for countervailing duties. Article VI, therefore, sets out the circumstances under which both antidumping and countervailing duties may be applied to imports that are either dumped or subsidized, respectively, and that can be shown to cause material injury to domestic producers.

The rationale for including these provisions in the GATT was wholly political. While the object and purpose of the GATT was the economic goal of facilitating international trade by progressively removing obstacles to international exchange, including discrimination, tariffs, quantitative restrictions and similar impediments, it was recognized that political support for such liberalization would be enhanced by providing governments with an "escape" clause, allowing them to re-impose protection on products deemed to be unfairly priced as a result of dumping or subsidization.

The GATT rules, subsequently expanded into much more detailed codes governing the application of these two remedies, tread a careful line between providing too much licence to vote-hungry politicians and zealous administrators responding to the importunities of industries under siege from lower-priced imports, and the need to let lower barriers and reduced discrimination lead to greater international trade and adjustment. The quarter century after the GATT entered into force in 1948 suggested that a reasonable balance had been struck. Barriers came down, trade and prosperity increased, and trade remedies were used sparingly. By the mid-1970s, however, in the face of increasing international trade and new international economic forces ranging from stagflation to the oil crisis, governments began to experience renewed pressure from older industries to deal with the impact of growing international competition. The response included innovative and more frequent resort to trade remedies.

Canada was not immune from these pressures. Canada had finally brought its antidumping legislation fully into conformity with the GATT in 1968, following the conclusion of the first Antidumping Code as part of the Kennedy Round negotiations, and the new provisions were being fully tested by domestic industries. Of particular concern to Canada, however, was the discovery by US industry that US countervailing duty legislation could be used to offset so-called domestic subsidies, was not limited to dutiable goods and did not require an injury determination. The critical case that confirmed this new reality involved the export of tires from Michelin's new production facilities in Nova Scotia,which had benefited from a variety of municipal, provincial and federal economic development subsidies. The new trend was confirmed in a further series of cases involving Canadian exports from fish to glass beads. Meanwhile, the number of new antidumping cases was mounting, particularly in the steel sector, and including on cross-border Canada-US trade.

Canada's response was to seek tighter discipline on US application of both remedies, while retaining scope for Canadian action, an objective shared with the European Communities and, to a lesser extent, Japan. The result was the delicate balance between export and import interests in the new antidumping and subsidies/countervailing measures codes concluded as part of the Tokyo Round of GATT negotiations in 1979.

Canadian industry's enthusiasm for the new rules, however, proved short-lived. The US legislation implementing the results of the Tokyo Round soon became known as the *Lawyers' Relief Act of 1979*. The legislation made the Department of Commerce responsible for administering the antidumping and countervailing duty laws, replacing the Treasury Department. At the same time, the Reagan administration's free-market approach to anti-trust legislation created a whole class of lawyers with renewed interest in the trade laws while the growing US budget deficit put pressure on the US dollar, leading to a growing trade deficit and calls for measures to stem the flood of imports. The result was a perfect storm of trade remedy action. Cases multiplied, including against Canada.

For Canadian industry, the new US appetite for trade remedies could not have come at a worse time. The Canadian market alone was no longer sufficient to warrant investment in new plant and equipment to remain competitive, access to the Canadian market for competing foreign products was being significantly eased as a result of the Tokyo Round tariff cuts, while

The quarter century after the GATT entered into force in 1948 suggested that a reasonable balance had been struck. Barriers came down, trade and prosperity increased, and trade remedies were used sparingly. By the mid-1970s, however, in the face of increasing international trade and new international economic forces ranging from stagflation to the oil crisis, governments began to experience renewed pressure from older industries to deal with the impact of growing international competition. The response included innovative and more frequent resort to trade remedies.

The Gazette, Montreal

President Reagan and Prime Minister Mulroney at the Citadel in Quebec City at the conclusion of the Shamrock Summit, March 18, 1985. They had agreed to pursue an agenda that resulted in the Free Trade Agreement on October 3, 1987.

access to the only market that was likely to be profitable in the short run had become uncertain as a result of the new taste for trade remedies. It did not take long for industry to begin petitioning the government to find a solution.

The answer was a Canada-US free trade agreement, one that would eliminate all remaining duties and customs barriers and introduce new disciplines on other impediments to the free flow of goods, services and capital across the border. A critical component of this agreement would be a new approach to cross-border price discrimination (dumping) and subsidization, based on concepts embedded in domestic competition law. Unfortunately, the US government did not see the issue on exactly the same terms. While prepared to admit the economic logic of Canadian ideas, US officials could perceive no political advantage. For Canadian manufacturers, the success of the FTA depended on shipping as much as three-quarters or more of their product to US customers on a secure and reliable basis, i.e., free of the threat of antidumping and countervailing duty complaints. For US manufacturers, for whom the Canadian market would rarely add up to more than one-tenth of their output, the threat of the odd Canadian trade remedy complaint was acceptable. On no issue was the reality of asymmetrical interests more stark.

To conclude an agreement acceptable to both countries, therefore, a second-best solution needed to be found. No Canadian government could sign an agreement that did not, in some measure, address the trade remedy conundrum. Similarly, no US administration could forward an agreement to Congress for approval that emasculated the ability of US producers to rely on trade remedies. The solution eventually worked out was both innovative and elegant. The two governments pledged to freeze their laws as they stood and continue discussions on a longer-term approach for a period of up to seven years. Meanwhile, application of the law by administering agencies on both sides of the border would become subject to binational rather than judicial oversight. Aggrieved parties to an antidumping or countervailing duty case could appeal any decision to a binational panel of experts who would exercise the judi-

cial oversight normally resident in domestic courts. While never overtly stated, Canadian industry and officials had become convinced that the administration of the trade remedy laws in the United States had become tainted by too many instances of bias favouring domestic interests. Whether true or not, the perception was real and the solution, therefore, directly addressed this concern and helped make the agreement acceptable to Canadian industry.

For Canadian manufacturers, the success of the FTA depended on shipping as much as three-quarters or more of their product to US customers on a secure and reliable basis, i.e., free of the threat of antidumping and countervailing duty complaints. For US manufacturers, for whom the Canadian market would rarely add up to more than one-tenth of their output, the threat of the odd Canadian trade remedy complaint was acceptable. On no issue was the reality of asymmetrical interests more stark.

The first two aspects of the agreement proved ineffective. The US Congress continued to tinker with the law, adjusting it to meet the needs of dissatisfied US customers, sometimes in egregious ways. The 2000 Byrd amendment, for example, which assigned the proceeds of antidumping and countervailing duty collection to the complaining industry, was summarily ruled as inconsistent with the WTO rules by a WTO panel; even then, it took five years for Congress to repeal the amendment.

Nor did a replacement regime prove negotiable. US officials never warmed to the idea and, once the NAFTA negotiations were initiated in 1992, no further effort was expended on this goal. Instead, the focus of attention for Canada became enshrining the review provisions permanently into the pending new agreement, whether or not it applied to Mexico. The result was a revised, but permanent, Chapter 19, that applied to all three parties.

How well has Chapter 19 worked? Surprisingly well. Over the course of the five years that the FTA was in force, i.e., until its replacement by the NAFTA, some 30 decisions were reviewed under its procedures. In addition, the United States launched three extraordinary challenge (EC) procedures of determinations by Chapter 19 binational panels. Following NAFTA's entry into force on January 1, 1994, the pace slowed somewhat, as did the number of cross-border antidumping and countervailing duty cases. Nevertheless, to the end of 2006, NAFTA Chapter 19 proceedings have been used to review 56 administrative decisions by Canadian and US agencies involving cross-border cases, two of which were further reviewed, and upheld, by extraordinary challenge panels. Many of these reviewed decisions involved multiple rulings in a single case or administrative reviews of long-standing cases.

Over the course of nearly two decades of cases, panels sustained some decisions by administrative tribunals and remanded others, seeking either clarification or stronger justification for the decision rendered or, in the absence of justification, determining that the decision be vacated. Experts reviewing the reasoning in such cases generally agree that panels, familiar with the economic and legal concepts, have performed their tasks ably and professionally and often more thoroughly than had been the case by the domestic courts. With the exception of the celebrated dissent a decade ago by Judge Malcolm Wilkie from the majority decision of an EC panel dealing with softwood lumber, Chapter 19 cases have raised little controversy and been widely accepted. Judge Wilkie's dissent in the softwood lumber decision gained extra cogency because the luck of the draw provided that each of the three EC panels was made up of two Canadian and one US judge. The charge of national bias, however, has no foundation in fact. US legal scholar and former lead counsel to the WTO, William Davey, for example, concluded that Judge Wilkie's reasoning had little merit while other reviews of the decisions have shown no evidence of national bias.

The US challenges of five panel determinations under the extraor-

TABLE 1: US AND CANADIAN RESORT TO FTA/NAFTA CHAPTER 19, 1989-2006

	Reviews of US determinations	Reviews of Canadian determinations
FTA 1989-93		
Antidumping	8	4
Subsidies/countervail	6	—
Injury	5	7
Extraordinary challenge procedures	—	3
NAFTA 1994-2006		
Antidumping	20	10
Subsidies/countervail	13	—
Injury	4	9
Extraordinary challenge procedures	—	2

Source: www.nafta-sec-alena.org/DefaultSite/index_e.aspx?DetailID=10#cn_ch19c

dinary challenge procedures, all of which were dismissed, must be understood as illustrative of the political difficulty faced by US authorities in rejecting an available channel of appeal. In the United States, as long as litigants are unhappy and there exists a channel of appeal, there is likely to be an appeal unless it has been clearly demonstrated that the chances of success are marginal at best. The five challenges included cases on pork, swine, softwood lumber, and magnesium, all high-profile cases brought forward by politically powerful industries. In all five cases, administration officials were unprepared to face the wrath of Congress and powerful industries without having demonstrated a willingness to exhaust all possible remedies.

From a Canadian perspective, US use of the challenge procedures proved beneficial because the three-judge panels in all five cases ended up setting a very high standard that appellants must satisfy. The decisions confirmed what for Canada had been the purpose of the procedure: a safety valve in cases of aberrant decisions or tainted panels; they were not meant to be used as a routine form of appeal. For Canada, this was a highly satisfactory result in ensuring that dispute settlement procedures would play their role in depoliticizing the management and resolution of conflict, an objective the US shares in the abstract but has difficulty applying in specific instances.

By any measure, the process has demonstrated a very high level of professionalism and lack of bias and, with the exception of a small number of high-profile cases, has succeeded in resolving disputes on a more principled, less political basis. The failure of the procedures to solve the softwood lumber imbroglio should not be laid at the doorstep of Chapter 19. Dispute settlement procedures by themselves cannot overcome a fundamental disagreement about something as basic as resource pricing. Add to that the fact that the US industry and their supporters in government behaved egregiously and Canadian provincial governments had no inclination to deal with the underlying policy difference, and the prospect of resolving this dispute were never very good. The solution found in the stand-alone, sector-specific agreement of last summer is, once again, showing signs of strain, underlining the extent to which this issue has proven uniquely difficult.

From a Canadian perspective, US use of the challenge procedures proved beneficial because the three-judge panels in all five cases ended up setting a very high standard that appellants must satisfy. The decisions confirmed what for Canada had been the purpose of the procedure: a safety valve in cases of aberrant decisions or tainted panels; they were not meant to be used as a routine form of appeal. For Canada, this was a highly satisfactory result.

More interesting, however, has been the gradual disappearance of trade remedies as a feature of cross-border trade in manufactured goods. Even as trade remedy regimes and cases have mushroomed on a global basis, they have virtually disappeared on a cross-border Canada-US basis. The high profile of the long-standing softwood lumber case projected a misleading image of the continuing importance of trade remedies in cross-border trade. There are currently only two US antidumping orders, and no countervailing duty orders, outstanding against Canadian products, both stemming from old cases which, as a result of sunset requirements, should gradually wither away. Canada for its part has four antidumping orders in force involving US products. There have been a limited number of new investigations over the past decade, all of which have been terminated at some stage as a result of insufficient evidence of dumping, subsidization or material injury. Multiple investigations involving softwood lumber notwithstanding, the trade remedy conundrum is now largely resolved, less because of the efficacy of Chapter 19 and more because of the investment logic of free trade: the extent of intra-corporate trade and other structural forms of commercial integration have virtually eliminated resort to trade remedies by firms in the manufacturing and industrial sectors.

Trade agreements, while focused on trade issues, are in fact about investment. By changing the rules governing trade, making cross-border exchange less subject to discrimination and border barriers, governments seek to influence private investment and firm behaviour. The FTA negotiations came at the end of a long period of expansion in international trade flowing from the successful implementation of a series of agreements starting with the reciprocal trade agreements of the 1930s and importantly consolidated in the 1947 GATT. Their core purpose was to reduce government capacity to interfere in market decisions about production, trade and investment, thus allowing cross-border trade and investment to flourish and contribute to prosperity.

Postwar trade policy assumed that international trade, investment and other cross-border transactions took place largely between firms and individuals in one country and unrelated firms and individuals in another. With the exception of raw materials, machinery and luxury products, experience suggested that goods and services were primarily consumed in the country in which they were produced by domestically oriented firms. Goods

and, to some extent, services were also produced for export but the successful penetration of a market often led to import-substituting investments and a return to the dominant pattern of domestic production for local consumption.

International transactions thus largely involved sales of primary goods, machinery and luxury goods; exports of excess production; establishment of foreign affiliates through foreign direct investment; transfers of technology through affiliates; and licensing arrangements, and the provision of various supporting services such as transportation, communication and insurance. Nevertheless, in response to market liberalization, particularly among members of the Organization for Economic Cooperation and Development (OECD), exports steadily increased as a share of global output, rising from about 7 percent in 1950 to about 15 percent by the mid-1970s, and doubling again by the end of the century.

The trade agreement model embodied first in the GATT and now the WTO and the plethora of regional and bilateral agreements worked superbly in fostering this rapid growth by nurturing predictability and certainty in the regulation of trade and investment flows and by providing the opportunity for periodic negotiations to reduce government interference in these flows. It also preserved political space for governments to protect some sectors of their economies from international trade in cases where the political pain is perceived to outweigh the economic gain. With the emergence of global and cross-border value chains, however, the model is proving increasingly irrelevant.

Over the past few decades, traditional international exchange has gradually begun to give way to a much more integrated kind, with more and more transborder transactions taking place within firms, among related parties or within integrated networks. Many more goods traded internationally today are parts and components for assembly into end products closer to the point of final consumption. Production is being geared to a much wider market, the range of goods and services that are exchanged internationally has widened considerably and capital and technology move between nations not only to promote import-substituting, but also export-oriented production. Global competition, scientific and technological breakthroughs, as well as consumer sophistication are shortening the product cycle and placing a premium on quality, manufacturing fluidity and innovation. International exchange now involves a much more complex and sophisticated range of economic transactions and is as likely to involve dealings among related than unrelated parties.

The integration that increasingly characterizes the global economy has a longer history at a bilateral Canada-US level. In an earlier era, proximity disposed Canadians to develop a trade and investment dependence on the US market and US capital. The exploitation of Canada's storehouse of raw materials and the establishment of miniature-replica branch plants both developed with heavy doses of US capital. Today, Canada exhibits a high level of both production and consumption dependence on the United States.

The integration that increasingly characterizes the global economy has a longer history at a bilateral Canada-US level. In an earlier era, proximity disposed Canadians to develop a trade and investment dependence on the US market and US capital. The exploitation of Canada's storehouse of raw materials and the establishment of miniature-replica branch plants both developed with heavy doses of US capital. Today, Canada exhibits a high level of both production and consumption dependence on the United States.

Its earliest modern manifestation involved the automotive industry. A unique set of circumstances at the time, captured in the 1965 Autopact, encouraged the development of integrated, cross-border production. Much of what is now commonplace was pioneered in the auto sector: in-house fragmentation and outsourcing on a continental rather than regional or national basis, followed by out-of-house cross-border fragmentation. The successful introduction of lean, just-in-time production techniques, pioneered in Japan and introduced in North America in the 1980s, further accelerated this fragmentation process.

Since the implementation of the FTA and NAFTA, fragmentation has become commonplace throughout North American industry, involving both manufacturing and service industries. High levels of both two-way intra-industry trade and foreign direct investment indicate continued cross-border integration and rationalization of production between Canada and the United States, as well as a deepening interdependence of manufacturing industries. Canada is the second-leading destination for US foreign direct investment while the United States is the prime destination of Canadian FDI. Proximity of the US and Canadian industrial heartlands, well-developed infrastructures and transparent legal systems all contribute to the highly integrated nature of the two economies. In turn, this integration contributes to a high level of trade as each country is the other's largest foreign market and leading supplier of imported goods.

Both cross-border and global supply chains today depend critically on relationships that extend well beyond arm's-length transactions between customer and supplier. As US business economist Stephen Blank notes, "Ottawa and Washington talk about the world's largest bilateral trading relationship. But we really don't trade with each other, not in the classic sense of one independent company sending finished goods to another. Instead we make stuff together;…[we] share integrated energy markets; dip into the same capital markets; service the same customers with an array of financial services; use the same roads and railroads to transport jointly made products to market; fly on the same integrated airline networks; and increasingly meet the same or similar standards of professional practice."

The emergence of a global economy has undermined a critical assumption supporting postwar trade policy: that it is governments that are the prime players in determining the flows of international trade. The rise of global and cross-border value chains, in which the key players are transnational corporations, has created a yawning gulf between the expectations of governance and the capacity for delivery. In the new dynamics of international trade, the critical factor is the intersection of firm-specific and location-specific value. Governments, in the interest of attracting value-adding activity to their location-specific jurisdictions, now compete in promoting policy settings that are congenial to increasingly mobile slices of production by removing barriers and providing incentives. The policy tools and agreements of the postwar years may have been critical to providing the framework that promoted fragmentation and integration, but they are no longer sufficient.

Trade remedy measures, for example, are wholly dysfunctional to the efficient operation of global and cross-border value chains. Disruption caused by the application of trade remedy measures can occur upstream or downstream from the imports subject to the measures. The application of an anti-dumping measure applied to steel imported to produce parts for engines manufactured in another country and installed in automobiles assembled in a third country, for example, protects domestic steel producers but raises costs not only for the engine parts manufacturer but for all firms in the value chain. For trade in non-value-chain goods, the impact of the duty is confined to the domestic economy and borne by users and consumers of the affected product. In value chain trade, the spread of the negative impact of the duty throughout the whole chain creates a powerful inducement to eliminate participation by firms in jurisdictions prone to trade remedy actions. Once integration reaches the stage evident between Canada and the United States, the logic of integration dictates that firms cannot afford to alienate either customers or suppliers by indulging in the costly process and fleeting benefit of a trade remedy complaint.

It would be nice to conclude that the FTA's Chapter 19 proved critical in resolving the trade remedies conundrum of 20 years ago. The reality, however, is a little different. The FTA as a whole, rather than Chapter 19 in particular, helped to accelerate a process that was already well in train at the time it was being negotiated: the integration of the two economies. The rash of trade remedy cases in the 1970s and 1980s reflected the dying gasps of a disappearing phenomenon: nationally organized and oriented industries. By the turn of the century, they had been largely replaced by globally and regionally organized firms and networks critically dependent on cross-border and global value chains. There is little room in this world for the disruptive impact of trade remedies. Only in less integrated resource industries have antidumping and countervailing complaints continued to make some strategic sense.

The virtual disappearance of trade remedies as a critical issue in bilateral relations is symptomatic of a larger challenge: the need to update the theory and practice of trade policy to reflect the new reality of globally and regionally integrated production. For Canada, the issues are not the remaining holdovers of the old regime, but the emerging challenges of a dysfunctional border, regulatory divergence and institutional capacity to govern integration. Ironically, the success of the old regime, including the FTA, created the conditions that now point to the new challenges. The FTA proved its value, but after 20 years, it is time to move on to challenges more closely attuned to current trade and investment conditions.

Since the implementation of the FTA and NAFTA, fragmentation has become commonplace throughout North American industry, involving both manufacturing and service industries. High levels of both two-way intra-industry trade and foreign direct investment indicate continued cross-border integration and rationalization of production between Canada and the United States, as well as a deepening interdependence of manufacturing industries.

Michael Hart is Simon Reisman Chair in Trade Policy at Carleton University's Norman Paterson School of International Affairs and a Distinguished Fellow of the Centre for Trade Policy and Law. Bill Dymond is Senior Executive Fellow at the centre. Both are former Canadian government officials who participated in the negotiation of the FTA and the NAFTA.