

# COUNTERVAILING DUTIES: EFFICIENCY AND PUBLIC CHOICE

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*This article summarizes the nature of countervailing duty legislation in Canada and the United States as permitted by the GATT Subsidies Code. It analyzes the gains and losses in the domestic economy due to a foreign subsidy and considers the effects of imposing a countervailing duty to counter a foreign subsidy. It considers the nature of the political forces that have led to countervailing duty laws and the imposition of countervailing duties in spite of losses that outweigh the gains from the imposition of such duties. A number of alternative approaches to increasing the political influence of those who lose from the imposition of countervailing duties are then considered. This is followed by a consideration of the forum (e.g., the domestic political forum, multilateral GATT negotiations, or bilateral trade negotiations) which would be most likely to lead to modifications in countervailing duty legislation in favour of those who lose from the imposition of countervailing duties.*

*The analysis is then applied to the Canada-U.S. negotiations on subsidies and countervailing duties. The conclusion with respect to the Canada-U.S. negotiations on subsidies and countervailing duties is that the narrow issue on which the negotiations are focused will lead to a set of political influences which will not be conducive to a reduction of countervail protection.*

*Cet article donne un aperçu de la nature des lois canadiennes et américaines sur les droits compensateurs adoptées en vertu du Code des subventions du GATT. Il analyse les effets positifs et négatifs d'une subvention étrangère sur l'économie nationale et étudie les effets de l'imposition de droits compensateurs visant à neutraliser une subvention étrangère. Il examine la nature des forces politiques qui ont conduit à l'adoption de lois sur les droits compensateurs et à l'imposition de droits compensateurs, bien que les effets négatifs de ces droits soient plus importants que les effets positifs. L'article aborde aussi plusieurs approches visant à accroître l'influence politique des personnes désavantagées par l'imposition de droits compensateurs. Il examine ensuite quel serait le meilleur forum (par exemple, le forum politique national, les négociations multilatérales du GATT ou les négociations bilatérales) pour faire modifier les lois sur les droits compensateurs dans l'intérêt des personnes lésées par l'imposition de ces droits.*

*Cette analyse est ensuite appliquée aux négociations canado-américaines sur les subventions et les droits compensateurs. Sur cet aspect, l'article conclut que l'objet limité des négociations suscitera des pressions politiques qui ne contribueront pas à une diminution des droits compensateurs.*

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## I. INTRODUCTION

This article examines the distributive effects of countervailing duty legislation and the political forces that lead to countervailing duty legislation. It suggests ways in which countervailing duty laws can take account of a broader range of distributive effects, especially the interests of consumers, and analyzes frameworks within which political forces may be altered to allow for a reduction in trade protection through countervailing duties. The analysis is then applied to assess the prospects for the development of countervailing rules over the next five to seven years under the *Canada-U.S. Free Trade Agreement*.<sup>1</sup>

When a foreign producer benefits from the assistance of a subsidy, the *Subsidies Code*<sup>2</sup> under the *General Agreement on Tariffs and Trade* (GATT) allows the importing ("domestic") country to impose a countervailing duty in an amount equal to the amount of the subsidy per unit where the subsidy on the products imported has caused, or threatens to cause, material injury to domestic producers.<sup>3</sup> Canada and the U.S. have countervailing duty laws that conform to those sanctioned by the *Subsidies Code*.<sup>4</sup>

Domestic producers can lose as a result of a foreign subsidy and can consequently gain by the imposition of a countervailing duty. Conversely, domestic consumers gain as a result of a foreign subsidy and lose the benefit of a subsidy when a countervailing duty is imposed. As the analysis to follow will show, the imposition of countervailing duties in response to foreign subsidies suggests that those who gain from countervailing duties probably cannot compensate those who lose and

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<sup>1</sup> Articles 1906 and 1907 of Part A of the *Canada-U.S. Free Trade Agreement*, S.C. 1988, c. 65 [hereinafter *FTA*] provide for a Working Group to develop rules concerning government subsidies, anti-dumping and countervailing duties within a five to seven-year period.

<sup>2</sup> *Agreement on the Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade*, 12 April 1979, Can. T.S. 1980 No. 42, 31 U.S.T. 513, T.I.A.S. No. 9619.

<sup>3</sup> Countervailing duties are a response to subsidies granted by foreign government X to its own producers. These subsidies reduce the cost of X's exports to country Y, which then imposes countervailing duties. However, countervailing duties do not respond to country X's subsidy which reduces the cost of X's products in a third country, Z, where country Y's products are also sold, making country Y's exports less competitive in Z's markets. This paper is concerned only with the scenario where country X's subsidies reduce the price of X's products in Y's domestic economy.

<sup>4</sup> In Canada, the *Special Import Measures Act*, R.S.C. 1985, c. S-15, and in the United States, the *Tariff Act of 1930*, 19 U.S.C. ss 1671-1671h, 1675 and 1677-1677k (1988).

still be left with a net gain.<sup>5</sup> In spite of this probable net loss, countervailing duty laws, by focusing on the material injury to domestic producers, allow domestic producers to impose losses on domestic consumers without compensation.

It will be shown that there may be a net gain from the imposition of a countervailing duty in the unlikely event that the foreign subsidy is predatory or intermittent. However, countervailing duty laws do not use predation or intermittency as a basis for imposing countervailing duties.<sup>6</sup> Other strategic considerations, such as the use of countervailing duties as a bargaining chip in trade negotiations or as a method of increasing domestic income in markets that are imperfectly competitive, are not generally considered to be strong arguments for imposing countervailing duties.<sup>7</sup>

Two questions are raised. First, why does the domestic policy toward countervailing duties allow domestic producers to impose losses on domestic consumers without compensation and with a probable net loss to the domestic economy? Secondly, what could be done to cause domestic countervail policy to respond more to domestic interests that gain from foreign subsidies (and lose from the imposition of counter-

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<sup>5</sup> The gains and losses are measured as areas in two-dimensional diagrams using demand and supply curves. The losses to producers from foreign subsidies are accordingly measured in terms of the compensation they would demand for incurring such losses. This estimate of the losses from a foreign subsidy, and accordingly, the gains from a countervailing duty, are likely to be on the high side. The gain to consumers from a foreign subsidy, and accordingly, the loss from a countervailing duty, are measured in terms of their willingness to pay, which is likely to be a relatively low estimate of their loss. The valuation of these gains and losses depends on the existing distribution of wealth and should in no sense be viewed as an ethically correct valuation of the gains and losses. This paper does not deal with the desirability of the distributional consequences of imposing or removing countervailing duties.

<sup>6</sup> It could be argued that there is a gain to the domestic economy from countervailing duty laws due to sharing in increased global efficiency by deterring trade-distorting subsidies, as noted *infra*: see nn. 52-54 and accompanying text. But whether countervailing duty laws lead to an increase in global efficiency is doubtful.

<sup>7</sup> If countervailing duties were used as a bargaining chip for other trade concessions this would not be a justification for their long-term retention or for the uncompensated loss to consumers of the countervailed imports. Recent international trade literature suggests that a national economy may benefit from protectionist policies where such policies are used as strategies for capturing rents in imperfectly competitive markets: see P.R. Krugman, *Is Free Trade Passé?* (1987) 1:2 J. OF ECONOMIC PERSPECTIVES 131. Although theoretically plausible as a justification for government intervention, there are a number of problems that make this a weak basis for intervention: see Krugman, *supra*, at 138-41. Even if imperfect competition justified protectionist intervention, a proactive intervention, such as direct subsidization appears more appropriate than a reactive intervention through countervailing duties: see Krugman, *supra*, at 134-38 for a discussion of when a strategic intervention may be justified.

vailing duties)?<sup>8</sup> An analysis of the second question can be used to address the likelihood of an agreement to reduce countervail protection under the *FTA*.

This paper considers the former questions in the following manner. Part II outlines the approach of the *Subsidies Code* and of Canadian and U.S. law toward assessing material injury in countervailing duty cases as well as outlining certain procedural aspects of the Canadian and U.S. law. Part III assesses the gains and losses in the domestic economy as a result of a foreign subsidy, including predatory and intermittent subsidies, and the gains and losses due to the imposition of a countervailing duty. Part IV notes the likely relative political influence that the gainers and losers from foreign subsidization have on domestic countervailing duty policy. Part V considers ways of altering the relative political influences of the gainers and losers to increase the influence of domestic interests that gain from foreign subsidies.

## II. MATERIAL INJURY AND PROCEDURAL PROTECTION IN COUNTERVAILING DUTY LAW

This Part provides a very brief outline of the assessment of material injury found in the *Subsidies Code*, Canadian and U.S. countervailing duty laws. In particular, the emphasis on domestic producer interests to the virtual exclusion of other interests such as domestic consumer interests will be noted.

Countervailing duty laws for contracting parties to the *GATT* are governed by Article VI of the *GATT*. Countervailing duty laws are further governed by the *Agreement on Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade, 1979*<sup>9</sup>, for those countries which are signatories to the *Subsidies Code*.

Article VI(6)(a) of the *GATT* provides that:

No contracting party shall levy any....countervailing duty on the importation of any product of the territory of another contracting party unless it determines that the effect of....subsidization....is such as to cause or threaten material injury to an established domestic industry, or is such as to retard materially the establishment of a domestic industry.

Article 6(1) of the *Subsidies Code* provides that:

A determination of injury for the purposes of Art. VI of the General Agreement shall involve an objective examination of both (a) the volume of subsidized imports and their effect on prices in the domestic market for like products and (b) the consequent impact of these imports on domestic producers of such products.

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<sup>8</sup> It is implicit in this question that domestic countervailing policy should respond more to domestic interests which gain from foreign subsidies. This paper assumes that domestic interests which gain from foreign subsidies are worthy of consideration and considers what could be done to cause domestic countervailing policy to respond more to these domestic interests.

<sup>9</sup> *Supra*, note 2 [hereinafter *Subsidies Code*].

Both the U.S. and Canada have enacted laws allowing countervailing duties to be imposed in a manner generally consistent with the *Code*.<sup>10</sup> The imposition of a countervailing duty requires two essential elements:

- (i) a subsidy;<sup>11</sup> and
- (ii) that the subsidy has caused or threatens to cause a "material injury" to, or to retard the establishment of, a domestic industry.<sup>12</sup>

In assessing "material injury", factors such as the following are considered:

- (i) the absolute increase in subsidized imports or the increase in subsidized imports relative to production or consumption in the importing country;<sup>13</sup>
- (ii) whether there has been significant price undercutting by subsidized imports relative to the price of a like product in the importing country or whether the effect of the subsidized imports is to depress prices or prevent price increases;<sup>14</sup>
- (iii) the impact on the domestic industry with reference to such factors as actual or potential decline in output, sales, market share, profits, productivity, return on investments, utilization of capacity, effects on domestic prices, as well as actual or potential negative effects on cash flow, inventories, employment, wages, growth, or ability to raise capital or investment.<sup>15</sup>

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<sup>10</sup> For U.S. provisions see the *Tariff Act of 1930*. Canadian provisions are found in the *Special Import Measures Act*.

<sup>11</sup> 19 U.S.C. ss 1671(a)(1) (1988); *Special Import Measures Act*, s. 3.

<sup>12</sup> 19 U.S.C. ss 1671(a)(2) (1988); *Special Import Measures Act*, s. 3.

<sup>13</sup> *Subsidies Code*, Art. 6(2). In the U.S., the *Tariff Act of 1930* has a roughly similar standard: see 19 U.S.C. ss 1677(7)(B)(i)(I) (1988). In Canada, "material injury" is broadly defined as "material injury to the production in Canada of like goods": see *Special Import Measures Act*, s. 2(1).

<sup>14</sup> *Subsidies Code*, Art. 6(2). There is a similar standard in the *Tariff Act of 1930*: see 19 U.S.C. ss 1677(7)(B)(i)(II) and (C)(ii) (1988). In Canada, cases interpreting "material injury" in the anti-dumping context have often focused on the suppression of prices: see, e.g., *Alloy Tool Steel Bars* (1985), 9 C.E.R. 215 at 223; *Photo Albums and Leaves* (1985), 9 C.E.R. 108 at 114; *Stainless Steel Bars and Wire* (1985), 9 C.E.R. 86 at 92; and *Wide Flange Steel Shapes* (1985), 9 C.E.R. 175 at 184.

<sup>15</sup> *Subsidies Code*, Art. 6(3). In the U.S., s. 771 of the *Tariff Act of 1930* provides for the consideration of the impact of imports on domestic producers of like products: see 19 U.S.C. ss 1677(7)(B)(i)(III) (1988). In examining the impact on the domestic industry, the United States International Trade Commission is required to consider, among other factors, the actual or potential decline in output, sales, market share, profits, productivity, return on investments, and utilization of capacity, as well as factors affecting domestic prices and actual and potential negative effects on cash flows, inventories, employment, wages, growth, ability to raise capital and investment: see 19 U.S.C. ss 1677(7)(C)(iii) (1988). In Canada, the assessment of "material injury" has focused on such factors as loss of domestic sales, loss of market share or growth of market share of import sales: see, e.g., *Photo Albums and Leaves* (1985), 9 C.E.R. 108 at 114; lost contracts: see, e.g., *Nickel and Nickel Alloy Pipe and Tubing* (1985), 9 C.E.R. 185 at 193-94; loss of employment and utilization of capacity: see, e.g., *Stainless Steel Bars and Wire* (1985), 9 C.E.R. 86 at 92.



The injury must be caused by the subsidized imports.<sup>16</sup> Other factors causing injury to the domestic industry must not be attributed to subsidized imports.<sup>17</sup>

With the possible exception of employment and wages, the factors considered in assessing material injury focus on the interests of domestic producers. There is no room in the injury assessment for the interests of domestic consumers who may well benefit substantially from foreign government subsidization leading to lower prices.<sup>18</sup> The benefits to domestic consumers might outweigh the losses to domestic producers (and their employees) but the current regime for countervailing duties does not take this into account.

Procedures for the assessment and imposition of countervailing duties in the U.S. and Canada can potentially be used to harass foreign competitors. Investigation into the existence of subsidization can be commenced by domestic producers by filing a petition or complaint with supporting evidence of a subsidy, injury and a causal link between the alleged injury and the subsidized imports.<sup>19</sup> If this complaint leads to an investigation the foreign producers will be subject to the costs of allowing and facilitating the investigation. If a subsidy is found to exist, a duty is imposed at that point before the final determination of whether

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<sup>16</sup> *Subsidies Code*, Art. 6(4). The *Tariff Act of 1930*, 19 U.S.C. ss 1671(a)(2) (1988) refers to material injury "by reason of imports" which benefit from a subsidy. *Special Import Measures Act*, s. 3, refers to the "subsidizing of goods" which "has caused, is causing or is likely to cause material injury....".

<sup>17</sup> *Subsidies Code*, Art. 6(4). Generally the causal link can be avoided in both the U.S. and Canada by pointing to other causes of injury such as a price leader in the domestic industry being responsible for reducing domestic prices: see, e.g., *Certain Table Wine from W. Germany, France and Italy*, USITC Pub. 1771, Inv. No. 701-TA-258; imports from a third country having caused the difficulties: see, e.g., *Potassium Chloride from Israel and Spain*, USITC Pub. 1596, Inv. No. 303-TA-15; strikes: see, e.g., *Asbestos Cement Pressure Pipe* (1979), 1 C.E.R. 42 at 47-48; or inefficient marketing by domestic producers: see, e.g., *Ceramic (Earthenware) Tiles* (1980), 2 C.E.R. 134 at 140.

<sup>18</sup> In Canada, the *Special Import Measures Act*, s. 45(1) does allow for an assessment of the "public interest". The "public interest" can be considered by the Canadian International Trade Tribunal in its hearings with respect to material injury. If the Tribunal is of the opinion that the imposition of a countervailing duty would not be in the public interest then it must report this to the Minister of Finance along with a statement of the facts and reasons for the opinion. The Minister could then exercise a discretion to reduce the duties payable: see s. 23 of the *Financial Administration Act*, R.S.C. 1985, c. F-11.

Any "person interested in an inquiry" may request an opportunity to make representations to the Tribunal with respect to the public interest: see *Special Import Measures Act*, s. 45(2). If the Tribunal makes a finding of injury then it is required to afford an opportunity to "persons interested" to make representations: see *Special Import Measures Act*, *ibid*.

<sup>19</sup> *Subsidies Code*, Art. 2(1); 19 U.S.C. ss 1671a(b)(1) (1988); *Special Import Measures Act*, s. 31(1) refers to a "complaint" that must be "properly documented", with a definition of "properly documented" in s. 2(1).

it is causing or is likely to cause material injury.<sup>20</sup> The determination with respect to material injury can take several months.<sup>21</sup>

The costs that this imposes on foreign producers, coupled with the uncertainty of a final countervailing duty order between the time of initiation of the investigation and a finding with respect to material injury, can have a deterrent effect on imports. Non-subsidized as well as subsidized imports may be deterred to the extent that mistakes can be made in the assessment of the existence of a subsidy or a material injury, and the causal link between material injury and subsidization. This added deterrent effect benefits domestic producers at the expense of domestic consumers who would benefit from the lower-priced products.

### III. GAINS AND LOSSES IN THE DOMESTIC ECONOMY

Countervailing duty law thus focuses on material injury to domestic producers. However, other domestic interests are also affected. This Part briefly examines the gains and losses to the domestic economy as a result of a foreign subsidy as well as the gains and losses from the imposition of a countervailing duty.<sup>22</sup>

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<sup>20</sup> In the U.S., the posting of a cash deposit, bond, or other security is to be applied upon an affirmative determination of the existence of a subsidy under 19 U.S.C. ss 1671b(d)(2) (1988), but before the final determination of injury under 19 U.S.C. ss 1671d(b) (1988). In Canada, a provisional duty can be charged or the posting of security can be required under *Special Import Measures Act*, s. 8(1), as am. S.C. 1988, c. 65, s. 26 before the final determination of injury required under the *Special Import Measures Act*, s. 43(1).

<sup>21</sup> In the U.S., the final determination of injury can be 120 days after the finding of a subsidy under 19 U.S.C. ss 1671b(b) (1988) and the requirement to post security under 19 U.S.C. ss 1671b(d) (1988): see 19 U.S.C. ss 1671d(b)(2) (1988). Similarly, in Canada the final determination of injury can be as much as 120 days after a preliminary finding of a subsidy under the *Special Import Measures Act*, s. 38, and the application of a provisional duty or posting of security under s. 8: see *Special Import Measures Act*, s. 43(1).

<sup>22</sup> The welfare effects of foreign subsidies are discussed in M. Trebilcock & J. Quinn, *The Canadian Antidumping Act: A Reaction to Professor Slayton* (1979) 2 CAN.-U.S. L.J. 101 at 111-13; see also J.J. Barcelo III, *Subsidies and Countervailing Duties – Analysis and a Proposal* (1977) LAW & POLICY IN INTL. BUS. 779 at 795, and J.J. Barcelo III, *The Two-Track Subsidies Code – Countervailing Duties and Trade Retaliation* in J. Quinn & P. Slayton, eds., NON-TARIFF BARRIERS AFTER THE TOKYO ROUND (Montreal: 1 R.P.P., 1982) 121 at 131-35. A recent and thorough examination of the effects of foreign subsidies and of the imposition of countervailing duties is provided in A.O. Sykes, *Countervailing Duty Law: An Economic Perspective* (1989) 89 COL. L. REV. 199 [hereinafter Sykes]. For simplicity of explication, the analysis presented assumes that the markets involved are perfectly competitive — that is, the actions of buyers and sellers do not affect the equilibrium price. This will normally occur when the market has large numbers of buyers and sellers, a homogeneous and divisible product, no barriers to entry or exit from the market, and perfect knowledge of product price and quality: see G.J. Stigler, *THE THEORY OF PRICE*, 3rd ed. (New York: Macmillan, 1966) at 87-89, and R.G. Lipsey, G.R. Sparks & P.O. Steiner, *ECONOMICS*, 2d ed. (New York: Harper & Row, 1976) at 260-66.

### A. *The Gains and Losses Due to a Stable Permanent Foreign Subsidy*

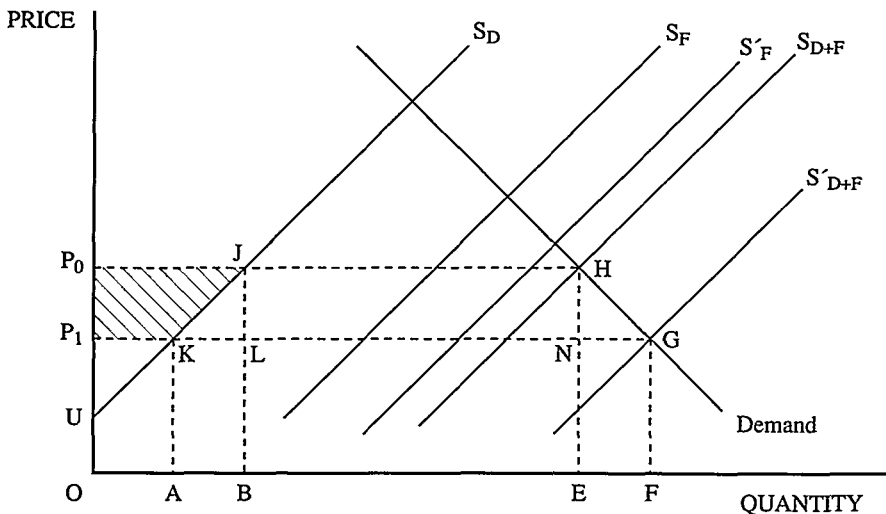
When a foreign country provides a subsidy that reduces the price of goods entering the domestic market it affects producers and consumers of those goods. It also affects the rest of the economy through linkages between the market for the imported goods and other sectors of the economy. The loss in producer surplus will be more than compensated for by a gain in consumer surplus. Resources freed from the production of the subsidized good will result in net gains to other sectors of the economy.

#### 1. *Lost Producer Surplus*

Figure I shows the effect of a foreign subsidy on the domestic market for the subsidized good. The domestic demand for the product is represented by the curve marked D. The domestic supply is marked  $S_D$ . Before the subsidy the foreign supply is determined by the foreign supply curve  $S_F$ . The sum of the domestic supply curve and the foreign supply curve gives the total supply curve  $S_{D+F}$  (the total quantity OE is supplied at a price of  $P_0$ ). Thus, before a foreign subsidy is introduced, the total quantity supplied is OE of which OB is supplied by domestic producers and BE is supplied by foreign producers.

When the foreign government subsidizes production of the good in its country, the foreign supply curve  $S_F$  shifts to  $S'_F$ . This shift occurs

FIGURE I



Lost Domestic Producer Surplus

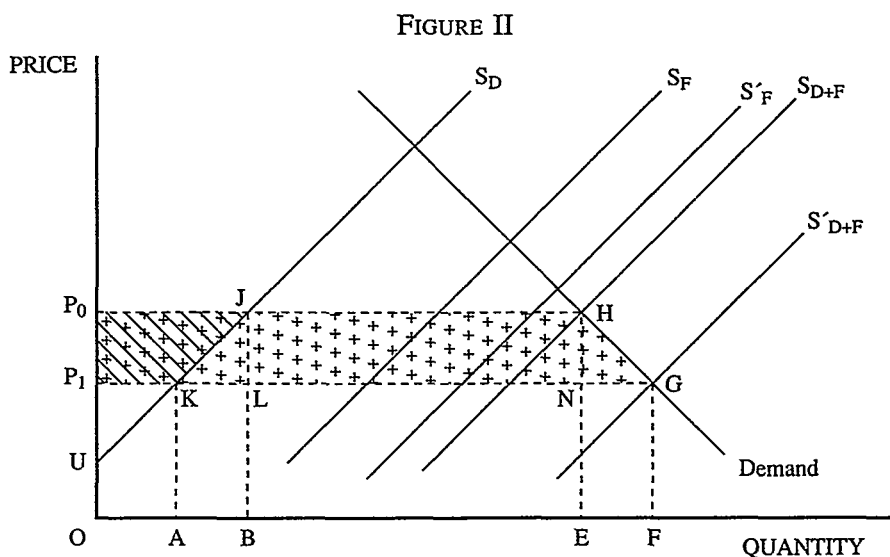


because for any given quantity of production the foreign producer, with the benefit of the subsidy, can produce that quantity at a lower cost. The sum of the domestic supply curve  $S_D$  and the new foreign supply curve shifts outward to  $S'_{D+F}$ . Thus, for any given price, the total quantity supplied will be greater than it was before the subsidy. The new market clearing equilibrium will be at point G yielding a price of  $P_1$  and quantity supplied of OF. At that price domestic producers will supply a quantity equal to OA.

Before the subsidy, domestic producers received a surplus equal to the area  $UJP_0$ . After the subsidy domestic producers receive a surplus equal to only the area  $UKP_1$ . Thus producers have a loss of surplus equal to the difference between these two areas which is equal to the area  $P_1KJP_0$ .

## 2. The Gain in Consumers' Surplus

The consumers of the imported product gain from the lower price for the product. Figure II, which replicates the situation depicted in Figure I, shows the gain in consumer surplus. The gain to consumers is the shaded area  $GHP_0P_1$ . This gain accrues in part to those consumers who consumed the product prior to the subsidy. They now consume the pre-subsidy quantity at a lower price. This gain corresponds to the area



Lost Domestic Producer Surplus



Gain in Consumer Surplus



$NHP_0P_1$ . The gain also accrues, in part, due to increased consumption of the product<sup>23</sup> and the consumer surplus associated with that increased consumption. This part of the gain corresponds to the area HNG.

Notice that the gain in consumer surplus outweighs the loss in producer surplus. Subtracting the producer surplus,  $JP_0P_1K$ , from the consumer surplus,  $GHP_0P_1$ , yields a net gain of KJHG.

In summary, when a foreign government subsidizes the production or export of a product the importing country will derive a gain in consumer surplus which at least offsets any loss in producer surplus.

### 3. *Gains From Freed Resources*

The foreign subsidy will increase the supply of the subsidized product in the domestic market. Domestic production will be reduced. Consequently, fewer resources will be used in domestic production of the product. The resources no longer used in domestic production of the subsidized product will be available for use in the production of other products. The increased supply of resources for the production of other products will reduce the price of the resources. This will increase the supply of other products which will reduce the prices of those products.<sup>24</sup> As depicted in Figure III, the lower price causes a loss in producer surplus of  $P_0ACP_1$  but leads to a gain in producer surplus of DCBE. Consumers gain  $P_0ABP_1$ . Since the consumers' gain is at least as much as the lost producer surplus corresponding to  $P_0ACP_1$  and since there is a producer gain of DCBE, there is a net gain from the resources freed from the production of the subsidized product.<sup>25</sup> Although there may be a net gain from the redeployment of resources displaced by a foreign subsidy it is noteworthy that the owners of those resources may suffer losses due to the reduction in the prices those resources command. The labour force in the industry facing competition from subsidized imports will be one of the displaced resources which may suffer a loss.

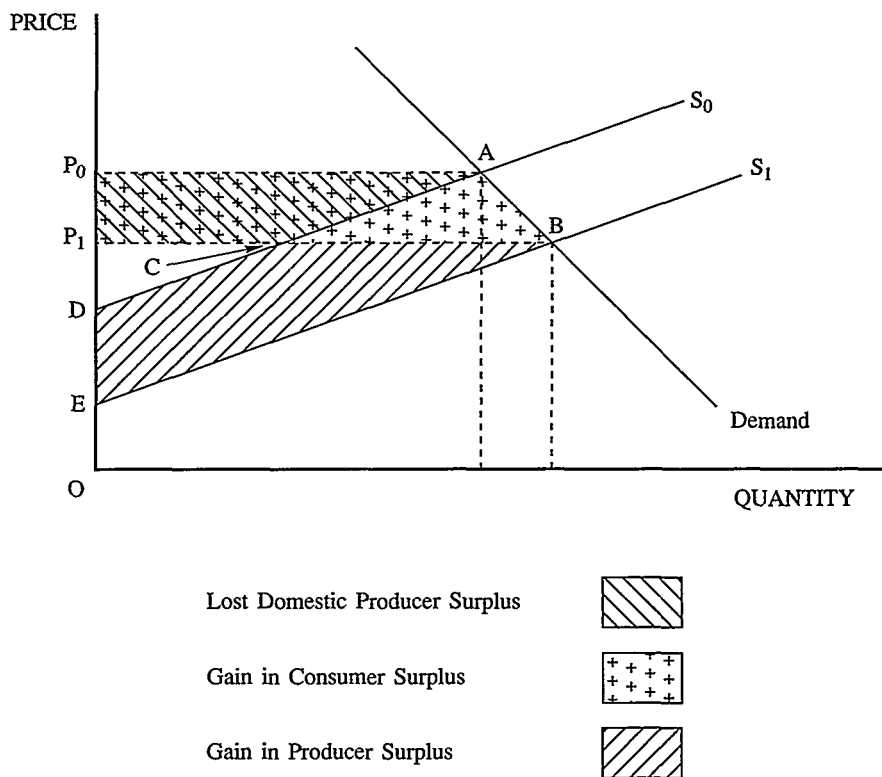
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<sup>23</sup> The increased consumption can come from consumers who were consuming the product before the subsidy was introduced and also from new consumers who did not consume the product before the introduction of the subsidy.

<sup>24</sup> The degree to which this occurs will depend on the competitiveness of the markets for the subsidized product, other markets into which resources are shifted and the price rigidity of the freed resources. It may be the case, for instance, that there is downward rigidity in the wages of labour resources freed from the production of the subsidized product. Consequently, subsidization may lead to a substantial period of unemployment for those who are no longer employed in production of the subsidized product.

<sup>25</sup> This is not to say there is a net gain to the global economy. Indeed, there is a net loss to the global economy if the effect of the foreign subsidy is to allocate resources to less valued uses. The allocative loss is, however, borne by residents of the country providing the subsidy and by residents of other countries consuming products produced by the industries in the subsidizing country from which resources were drawn away by the subsidy. But, from the viewpoint of the domestic economy, the misallocation effects are nil (or at least nominal).

FIGURE III  
THE EFFECT OF FREED RESOURCES ON MARKETS  
TO WHICH THE FREED RESOURCES MOVE

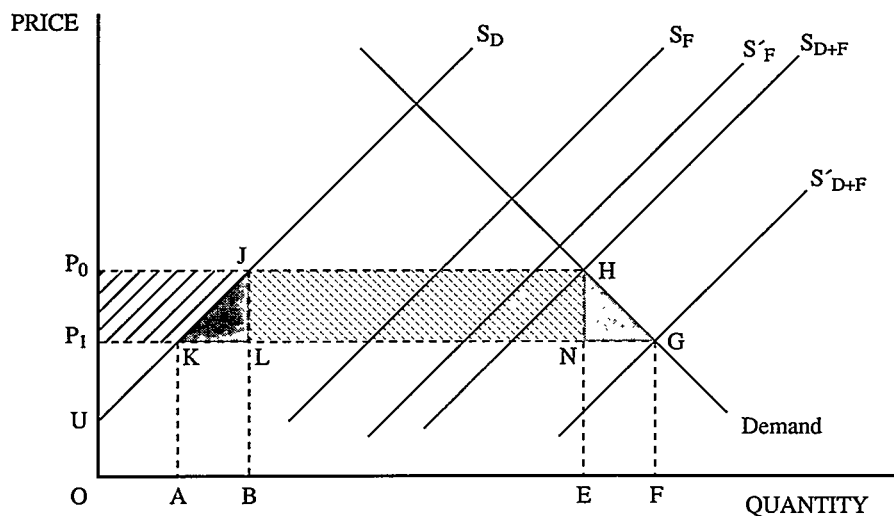


The shift of resources from the production of the subsidized product to the production of other products is not costless. It may require that people move from one job to another and may require that people move from one location to another. They may need to be retrained for a new job.<sup>26</sup> They may be without a job for some time. These changes involve monetary and psychological costs. Production facilities may be dismantled and equipment moved. Transactions may be required to shift capital from investment in the production of the subsidized product to investment in the production of other products. These changes will also involve costs. These "adjustment costs" must be weighed against the gains in consumer surplus and from freed resources noted above.<sup>27</sup>

<sup>26</sup> People may need to be retrained when they lose jobs due to import competition, since it will be less likely that they will be able to find employment with a domestic producer in the same industry. Other domestic producers may also be cutting back on production: *see Sykes, supra*, note 22 at 211.

<sup>27</sup> An argument that countervailing duties may be the best "second-best" method available to deal with adjustment costs is discussed and discounted by *Sykes, ibid.* at 229-40.

FIGURE IV  
GAINS AND LOSSES FROM IMPOSING A COUNTERVAILING DUTY



Gain in Domestic Producer Surplus



Lost Consumer Surplus



Net Loss in Consumer Surplus



Gain from Duty Revenues



Assuming the subsidy is permanent,<sup>28</sup> adjustment costs will be incurred only once. The gains in consumer surplus, net of the loss in producer surplus, will be realized in perpetuity. This increases the likelihood that the gains will more than offset the adjustment costs.

#### B. *Gains and Losses from Imposing Countervailing Duties*

Although the imposition of a countervailing duty will lead to a gain in producer surplus and in countervailing duty revenues to the domestic government, as the foregoing analysis suggests, it is likely that it leads to a net loss due to the loss in consumer surplus.

Figure IV replicates Figure I. With the imposition of a countervailing duty the domestic government will collect a duty which will generate revenues. The duty will be such that it raises the foreign supply price

<sup>28</sup> The case of an intermittent subsidy is dealt with below in Part III(D).

to  $P_0$  (in other words, a duty of  $P_0$  minus  $P_1$  on each unit imported). The revenues will then be the duty  $(P_0 - P_1)$  times the number of units imported (and the number of units imported, or supplied by foreign producers, will be  $EO - BO$ ). This corresponds to area JHNL. Domestic producers will realize a gain corresponding to area  $P_0JKP_1$ . This will offset the lost consumer surplus upon the imposition of the duty which corresponds to the area described by  $P_0HGP_1$ . However, there will not be compensation for all of the lost consumer surplus. There will remain a net loss in consumer surplus corresponding to the triangles depicted in JKL and HNG. Thus, in spite of the gain to domestic producers and the collection of the duty by the domestic government, there will be a net domestic welfare loss from the imposition of countervailing duties.

The procedural apparatus by which countervailing duties are typically assessed permits domestic producers to harass foreign producers.<sup>29</sup> The probable effect is that foreign producers will be inclined to avoid the cost and uncertainty associated with the process of assessing countervailing duties. They will do so by either reducing exports of the subsidized product to the country with the countervailing duty legislation or by increasing the price of the product exported to the country with the countervailing duty legislation. A reduction in imports of the subsidized product or an increase in the price of the subsidized product will reduce the gain in consumer surplus from the subsidization. To the extent that this prevents a duty from ultimately being imposed it reduces the compensating gain from the collection of the duty. Thus the procedural apparatus associated with countervailing duty laws will exacerbate the loss to domestic consumers from the imposition of a countervailing duty.

### C. *Predatory Subsidies*

A countervailing duty might be justified as a response to a predatory foreign subsidy. A predatory subsidy would be a subsidy designed to force domestic producers out of the business by depressing the price of the subsidized product below the level at which it is profitable to produce the product. Once the domestic producers are forced out of business the subsidized foreign producers could then increase prices to more than the pre-subsidy domestic market price.<sup>30</sup> In effect, the foreign producers recoup more than the amount of the subsidy by obtaining monopoly profits after other competitors are forced out of the market. The welfare effects of this for the domestic country can be considered in two steps. Initially, when the subsidy lowers the price of the product, from  $P_0$  to  $P_1$ , as in Figure V, the situation would be the same as described above with respect to lost producer surplus, increased consumer surplus and gains from freed resources. After the domestic producers are forced out

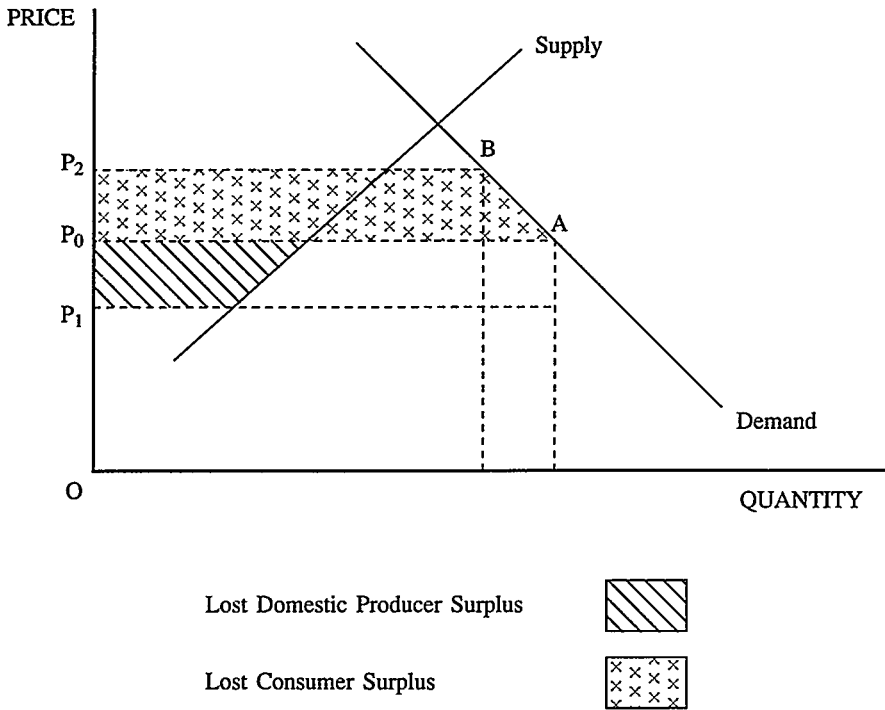
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<sup>29</sup> See Part II, *supra*.

<sup>30</sup> This is known as "classical predation": see, e.g., D.G. McFetridge & S. Wong, *Predatory Pricing in Canada: The Law and the Economics* (1985) 63 CAN. BAR REV. 685.



FIGURE V



of business and the price of the product is raised, from  $P_1$  to  $P_2$ , there will be a loss in consumer surplus corresponding to the area  $P_0ABP_2$ . If the present value of the lost consumer surplus due to the future increase in price, plus the lost producer surplus, is greater than the present value of the gain from freed resources and initial gain in consumer surplus, then there will be a net loss. Such a result would justify the use of a mechanism to countervail the predatory effect.

Predation, however, is probably an unprofitable strategy and is thus an unlikely basis for foreign subsidies.<sup>31</sup> To force out competitors the price will have to be reduced to a level that makes it unprofitable for other producers to continue to produce the product. The predator who, in the case of a predatory subsidy, is the foreign government providing the subsidy must thus incur substantial losses. These losses increase as domestic competitors reduce production and drop out of the market since the predator must replace this production to keep the prices down. Further, lower prices attract new consumers to the market requiring

<sup>31</sup> A number of scholars claim that predation is improbable. See, e.g., F.H. Easterbrook, *Predatory Strategies and Counterstrategies* (1981) 48 U. CHI. L. REV. 263 at 265-318; J.S. McGee, *Predatory Price Cutting: The Standard Oil (N.J.) Case* (1958) 1 J.L. & ECON. 137; and Trebilcock & Quinn, *supra*, note 22 at 104-08. With respect to the likelihood of predatory subsidies and the appropriateness of current countervailing duty laws as a response, see Sykes, *supra*, note 22 at 241-50.

further production on which the predator will incur losses. Thus the losses which need to be subsidized will be substantial.

The gain to be recouped from subsequent monopoly profits will require that the monopoly position be maintained for a substantial period of time. This will require barriers to entry in the domestic market. If the domestic industry was competitive before the predatory subsidy then it is likely that there will be potential for entry after the predation. These and other problems<sup>32</sup> suggest that predation is probably unprofitable and is therefore an unlikely strategy.

Even if a subsidy is predatory in nature it is unnecessary to have countervailing duty laws to deal with the problem. Predation is considered anti-competitive and is thus dealt with under competition or anti-trust laws. Predatory subsidies, with perhaps some modification, could also be dealt with in competition or antitrust laws. Even if one retained countervailing duty laws against predatory subsidies, they should be designed to identify predation. Current countervailing duty laws focus on the existence of a subsidy and the presence of material injury<sup>33</sup> and do not attempt to identify predation.<sup>34</sup>

#### D. *Intermittent Subsidies, Destabilization and Adjustment*<sup>35</sup>

A foreign government's subsidization policy might not be stable.<sup>36</sup> It might subsidize production of a product for a few years and then, for whatever reason, cancel the subsidy. A few years later it might reinstate the subsidy. Similarly, the foreign government might vary the amount of the subsidy from year to year in an unpredictable fashion.<sup>37</sup> A subsidy subject to either of these types of changes will be referred to hereafter as an intermittent subsidy.

When a foreign subsidy is introduced it causes a reduction in domestic production of the subsidized product. Adjustment costs of the type referred to in Part III(A)(3) above will be incurred. Although necessary to shift persons and assets to more valuable uses, these

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<sup>32</sup> The reasons for the improbability of predation are discussed at much greater length in the articles noted in note 31, *supra*.

<sup>33</sup> See Part II for a brief discussion of the elements of countervailing duty laws.

<sup>34</sup> Identifying predation is difficult in the normal non-subsidization case: see McFetridge & Wong, *supra*, note 30. It is even more problematic where predation is due to a subsidy: see the discussion in Part V(A)(3).

<sup>35</sup> The problem of intermittency is discussed with respect to dumping in Trebilcock & Quinn, *supra*, note 22 at 108-11.

<sup>36</sup> The effects of such instability or intermittency were discussed with respect to dumping by J. Viner, in *DUMPING: A PROBLEM IN INTERNATIONAL TRADE* (Chicago: University of Chicago Press, 1923) c. 8, especially at 140-41. An intermittent subsidy argument for countervailing duty laws is questioned by Sykes, *supra*, note 22 at 238-39.

<sup>37</sup> If the intermittency were predictable then the market could take the variations into account in determining levels of investment in order to minimize the adjustment cost problem.

adjustment costs do not directly produce anything of value to the domestic economy. These costs should be incurred only if the adjustments result in a net gain to the domestic economy. Intermittent subsidies may reduce productivity and increase the cost of capital in the production of the subsidized product. Productivity may be diminished due to the deterioration of labour skills and the failure to maintain and replace capital equipment during periods of disruption.<sup>38</sup> The cost of capital may increase due to the increased variability in earnings resulting from the intermittency of subsidization.<sup>39</sup> If the adjustment costs and any reduced productivity and increased cost of capital are compensated for by the long-term gains discussed in subpart (A) above then it is worthwhile to incur these costs. However, if the foreign subsidy keeps changing such that the domestic economy is frequently required to incur adjustment costs as well as a significant reduction in productivity and an increase in the cost of capital in the production of the subsidized product, then the foreign subsidization may cause net welfare losses to the domestic economy.<sup>40</sup> Protection against such losses could form the basis of an argument in favour of countervailing duties.

It seems unlikely that intermittency in a foreign government's subsidization policy towards a specific product would be sufficient to cause adjustment costs that wipe out the domestic welfare gains from the foreign government subsidies. Presumably some set of political forces have brought the subsidy about. Unless these political forces are subject to frequent change which is sufficiently radical to bring about substantial variations<sup>41</sup> in subsidization, then the costs to the domestic economy are not likely to outweigh the long-term gains to the domestic economy from the foreign subsidization.

If the problem with foreign subsidization is that it is intermittent, then the countervailing duty law should be designed to respond to intermittency in subsidization. The current countervailing duty laws prescribed in the *Subsidies Code* and in force in Canada and the U.S. make no attempt to identify whether a subsidy is intermittent.<sup>42</sup>

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<sup>38</sup> See Trebilcock & Quinn, *supra*, note 22 at 110.

<sup>39</sup> *Ibid.*

<sup>40</sup> The problem may be exacerbated where a number of foreign governments subsidize the production of the product in an intermittent fashion. However, it may not exacerbate the problem of intermittency if foreign subsidizations tend to counterbalance one another and reduce the net intermittent effect on the domestic market.

<sup>41</sup> The variations would have to be substantial enough to cause the adjustment costs, productivity decreases and cost of capital increase to be great enough to outweigh the gains noted in Part III(A).

<sup>42</sup> Identifying the intermittency of a subsidy after the subsidy has been used in an intermittent fashion over a number of years may be difficult enough, but identifying the potential for intermittency *ex ante* will be very difficult. See Part V(A)(3).

### E. Summary

The gain in consumer surplus due to a foreign subsidy will typically outweigh the lost producer surplus and adjustment costs. The imposition of countervailing duties would forfeit the gain in consumer surplus and the gains from freed resources which would not be fully compensated for by the resulting gain to domestic producers and the duty revenues collected by the domestic government. Those who gain from the imposition of countervailing duties can probably only compensate those who lose where the foreign subsidy is predatory or intermittent — neither of which is likely.

## IV. POLITICAL INFLUENCES ON COUNTERVAILING DUTY LAW

In the face of the gains available to the domestic economy from foreign subsidies, what accounts for the presence of countervailing duty laws and the policy in the *Subsidies Code*? This Part examines a number of factors relating to the relative political influence of the various interests affected by foreign subsidies which can account for the existing countervailing duty laws.

The analysis of the political influences considered below begins from the proposition that the interest groups act according to their self-interests. When affected by a particular political issue, interest groups will act in a way that effectively responds to the costs and expected benefits from lobbying in favour of a particular outcome. Costs will be incurred to the point that the marginal expected benefit associated with the incurrence of an additional increment of cost just equals that incremental cost. The expected benefits will depend on the benefits perceived to be associated with particular outcomes and on the probability of those outcomes.<sup>43</sup>

Figure VI depicts this concept with respect to achieving varying degrees of an objective (such as the degree of protection or the reduction in the degree of protection).<sup>44</sup> The benefit curve indicates the expected benefit associated with obtaining a given degree of the objective. The interest group will invest up to  $C_0$  where the marginal expected benefit equals the marginal cost.

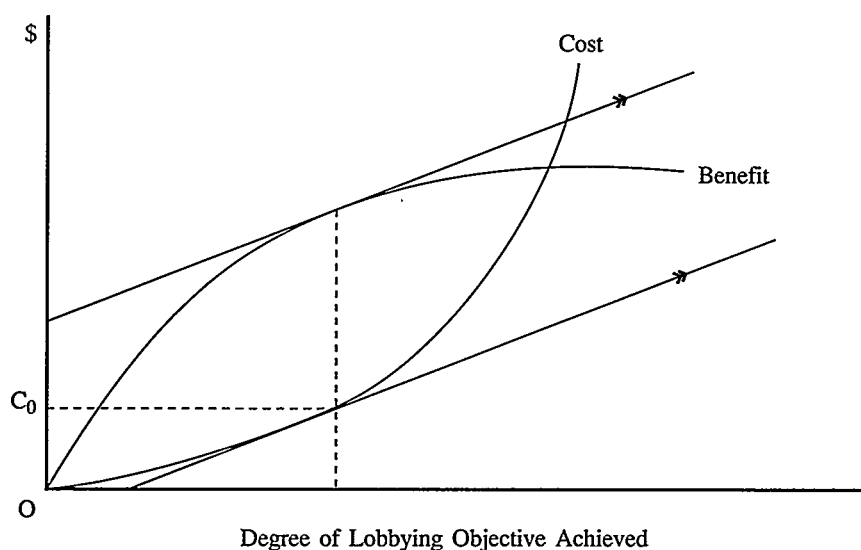
In these terms, the argument as to how countervailing duty laws come about, in spite of the net welfare loss that such laws probably lead to, is of the following form. Those who gain from countervailing duty laws continue to have net marginal benefits from substantially more lobbying efforts than those who lose from countervailing duty laws.

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<sup>43</sup> The interest groups will demand policies and political decision-makers will supply policies which maximize the votes they receive. Such a market for policies is presented in A. Downs, *An Economic Theory of Democracy* (New York: Harper & Row, 1957).

<sup>44</sup> This diagram is adapted from a diagram in B.S. Frey, *INTERNATIONAL POLITICAL ECONOMICS* (Oxford: Basil Blackwell Publisher Ltd, 1984) at 25.

FIGURE VI



Domestic producers who could benefit from the protection afforded by the use or threat of countervailing duties will be inclined to support countervailing duty laws. Domestic producers can benefit from countervailing duties to the extent they supply the domestic market. Their expected benefit will depend on the likelihood that a foreign government will subsidize the product they produce, or a close substitute to the product, the likelihood that it will be imported into the domestic country, and the likelihood that they can obtain countervailing duties under whatever countervailing duty regime they can persuade the government to provide. A number of domestic producers may supply primarily the domestic market and may already face competition from subsidized imports. These domestic producers are likely to perceive a relatively high expected benefit from the enactment of countervailing duty laws.

Producers who would benefit from countervailing duty laws, particularly those who would benefit substantially, are likely to be much fewer in number than the consumers who lose from having such laws. The effects of this difference in numbers are twofold. First, individual producers will gain much more on average than individual consumers will lose. This is because the gain to producers is spread over a relatively small number while the loss to consumers will generally be spread over a relatively large number of consumers.<sup>45</sup> Secondly, the relatively smaller number of producers will permit producers to organize much more effectively.<sup>46</sup> Thus producer interests will tend to be more signif-

<sup>45</sup> See M.A. Biggs, *THE CHALLENGE: ADJUST OR PROTECT* (Ottawa: The North-South Institute, 1980) at 122. See also M. Olson, *THE LOGIC OF COLLECTIVE ACTION* (Cambridge: Harvard University Press, 1965) especially at 22-43 and at 143-44.

<sup>46</sup> Olson, *ibid.*

icantly affected by countervailing duty laws and will be much more easily organized than consumer interests. The political forces will thus tend to favour the imposition of countervailing duty laws.

As noted in Part III(A)(3) owners of resources supplied to the domestic producers of the subsidized product will lose as a consequence of the foreign subsidy. Thus they will likely benefit from countervailing duty laws if the producers they supply face competition from subsidized foreign imports. Where these owners of resources are well organized they could exert a substantial influence in favour of countervailing duty laws.<sup>47</sup> Unions representing workers in industries facing subsidized imports, or potential import subsidization, may well have been a substantial political interest group in the formulation of countervailing duty legislation and may well account for the consideration of the effect on employment and wages in the determination of material injury.<sup>48</sup>

There may be domestic producers who would oppose countervailing duty laws. Producers of this type would presumably foresee little or no benefit to themselves from countervailing duty laws if the subsequent imposition of a countervailing duty leads to protective measures in foreign markets to which they export. Domestic export-oriented producers and especially subsidized domestic export-oriented producers would seem most likely to fall into this category. The perceived benefit to these producers from preventing the enactment of countervailing duty laws would likely be much less than the perceived benefit of countervailing duty laws to pro-countervailing duty law producers. The effect of countervailing duty laws on producers who might oppose them will depend on their expected loss from foreign protection resulting from countervailing duty laws or the imposition of countervailing duties. This will depend on the countervailing duties resulting in protectionist measures by the foreign government of the country to which the producer exports and on the probability that the protectionist response will apply to the producer. The producer might also weigh the potential loss against a potential gain from the use of the countervailing duties to provide leverage in negotiations for a reduction of foreign protection. These factors will cause export-oriented producers to be less significantly affected by the enactment of countervailing duty laws than producers that primarily supply the domestic market, especially where the producers primarily supplying the domestic market already face competition from subsidized imports. For these reasons it is likely that there is a significant range over which those who gain from countervailing duty laws obtain higher marginal expected benefits from lobbying for such

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<sup>47</sup> See Biggs, *supra*, note 45, where the tendency of labour unions to favour protectionism when the industry faces import dislocation is noted. See also S.P. Magee, *Three Simple Tests of the Stolper-Samuelson Theorem* in P. Oppenheimer, ed., *ISSUES IN INTERNATIONAL ECONOMICS* (Stockfield, Northumberland: Oriel Press, 1980) at 138-53 showing the alignment of capital and labour by American industry in response to the U.S. Trade Reform Act of 1973.

<sup>48</sup> See Part II, *supra*.

laws at lower marginal costs of lobbying than those who lose from countervailing duty laws.

This relative dominance of domestic producer interests is not unconstrained.<sup>49</sup> Besides the relatively weaker opposition to countervailing duties that would come from consumers and export-oriented domestic producers, there is likely to be at least some opposition from domestic producers who use subsidized imports as inputs in their production process. These producers are likely to be a smaller and thus more easily organized group than consumers or export-oriented domestic producers. They may well also suffer substantial losses from countervailing duties and thus may benefit substantially from opposing countervailing duty legislation. Further, with respect to all the interest groups who lose as a result of countervailing duty legislation, the stronger the protection sought by domestic market-oriented producers the greater is the effect of the protection on interests that lose as a result of the protection. Increased protection is thus likely to raise greater opposition to protection. At some point the relative lobbying strengths are in equilibrium and the resulting legislation reflects this equilibrium.

The analysis of interest groups trading off costs and benefits from lobbying provides the demand for countervailing duty legislation. If politicians, who are in a position to supply the countervailing duty legislation, are viewed as self-interested and as satisfying their self-interest through being re-elected then they may be inclined to provide countervailing duty legislation. The relatively dominant political influence of domestic market-oriented producers will mean that politicians will perceive that more votes are likely to be obtained from providing the countervailing duty legislation. Indeed, having decided that countervailing duty legislation will provide them with more votes, politicians may then be inclined to design the legislation to reduce the votes lost from those who oppose the legislation. One method of doing this is to make the legislation complex and obscure thus making it difficult to become informed as to the effect of the legislation. There may also be a tendency to delegate decision making powers to an administrative body to make the politician less accountable for particular actions. The politician can then respond to any particular action as being the only action legally possible and that the only available course of action is to seek a legislative response. Countervailing duty legislation adopts both of these methods of reducing lost votes. The effect of these methods is to raise the costs of organizing opposition to countervailing duty legislation since it will be more costly to inform voters about the complex nature of the legislation and voters have to be rallied around amending the legislation rather than around a particular situation in which a countervailing duty is sought to be imposed.

Although this analysis of relative influence is conjectural and awaits empirical support, it does seem to square with the domestic

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<sup>49</sup> The result cannot be as one sided as is implied by Downs, *supra*, note 43 at 255-56.

producer-oriented nature of domestic countervailing duty laws. It is not inconsistent with evidence that suggests protection in the form of tariffs tends to be correlated with industry decline, industry concentration, and the weakness of opposition.<sup>50</sup>

## V. TOWARD A MORE BALANCED REPRESENTATION OF INTERESTS IN THE COUNTERVAILING DUTY ISSUE

This Part considers ways of increasing the consideration of interests other than those of domestic producers, given that those who gain from countervailing duties probably cannot compensate those who lose and still have a net gain. To begin with, ways of changing countervailing duty laws to allow a broader range of interests to be taken into account are examined. Then the question of how these changes can be brought about in face of the prevailing relative political influences is considered.

### A. *Increasing the Consideration of Interests that Lose from Countervailing Duties*

The following are possible methods of increasing the consideration of interests other than those of producers facing competition from subsidized imports:

- (i) broaden the "injury" test so that the concerns of domestic interests who gain from foreign subsidization must be considered;
- (ii) put the onus of proof of material injury on the complainant and collect a duty only after proof of the existence of a subsidy and proof of material injury;
- (iii) require a finding of intermittency or predation before a countervailing duty can be imposed;
- (iv) repeal countervailing duty laws.

#### 1. *Broadening the Injury Test*

The definition of "injury" could be expanded such that it required a balancing of all the gains and losses resulting from a subsidy rather than just focusing on domestic producer interests. If the regulatory body assessing injury were required to take these other factors into account then consumers would be more strongly represented in individual cases. The affected foreign producer could make arguments not just of the sort that questioned material injury to domestic producers and attacked the causal connection between the subsidy and the injury, but could also claim that the subsidy brought compensating gains to the domestic economy. This could be further strengthened by having a publicly funded

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<sup>50</sup> See H.P. Marvel and E.J. Ray, *The Kennedy Round: Evidence on the Regulation of International Trade in the United States* (1983) 73 AMER. ECON. REV. 190.



representative who would be required to make representations at the hearing on behalf of consumers.

Having the concerns of those who gain from subsidized imports taken into account would increase the likelihood that the injury determination accounted for a broader spectrum of the effects of subsidized imports. The public representative could, for instance, provide evidence of the consumer gain from the subsidization and could refute evidence as to the extent of injury suffered by the complainant as a result of the subsidization. The use of such a publicly funded representative could overcome some of the organizational problems encountered by large and dispersed interest groups. This would be of greater assistance in the case where there are numerous consumers of the imported product each consuming relatively small quantities of the product.

Although broadening the injury test seems to be consistent with the analysis in Part III in that it could allow representation of all the gainers and losers in determining injury, it would be unlikely that this would give an efficient result since it would not overcome the relatively dominant influence of the producers who lose as a result of subsidized imports.

## 2. *Reducing Procedural Protectionism*

As noted in Part II, the procedures that countervailing duty legislation provides for assessing the existence of a subsidy and material injury causes foreign producers to face significant cost and uncertainty. It also permits domestic producers to harass foreign producers with countervail complaints or the threat of such complaints. This deters the importation of subsidized goods that would lead to a net increase in domestic social welfare.

If the complainants had to pay a user fee for the costs of the investigation as to the existence of a subsidy,<sup>51</sup> and if they had the onus of proving material injury, the costs of initiating a countervail complaint would be substantially increased. This would deter the use of such complaints to harass foreign producers. Further, if foreign producers were only required to pay a duty after the existence of a subsidy and material injury were demonstrated, then the potential for harassment and the uncertainty associated with the assessment of countervailing duties would be substantially reduced.

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<sup>51</sup> The user fee should be at least sufficient to cover the domestic government's administrative costs associated with the investigation. Arguably the injury to domestic producers, even if it is the only welfare effect taken into account, should at least be large enough to make it worthwhile to incur the administrative costs to correct the loss. It seems reasonable therefore to charge the complainants for the administrative costs incurred.

### 3. *An Intermittency or Predatory Intent Test*

The analysis in Part II suggests that social welfare can be improved by not imposing countervailing duties, subject to two possible exceptions: intermittent subsidies and predatory subsidies. This suggests that countervailing duty laws require a finding of either intermittency or predatory intent associated with the subsidy in question before a countervailing duty is imposed.

A test of intermittency or predatory intent should have the effect of substantially reducing the number of successful countervailing duty claims relative to the number of successful claims that would flow from having only a material injury test. There would still be potential for the imposition of countervailing duties that would be detrimental to social welfare since there might be a subsidy with intermittency or predatory intent in a situation that would still leave a net gain to the domestic economy if no duty were imposed. One might still want to have a form of public intervention, such as described in Part V(A)(1) above, so that a balancing of the gains and losses is made.

A test of intermittency may be very difficult to formulate. Intermittency might not become apparent until several subsidy changes causing serious adjustment costs have already occurred. Defining an *ex ante* test for intermittency may prove to be an insurmountable task. One is thus left with making a judgment on the likelihood of intermittency. As noted in Part III above, substantial intermittency in subsidies seems unlikely. Thus, it may be preferable to drop intermittency as a basis for the imposition of a countervailing duty.

This would leave predatory intent as the only basis for a countervailing duty. A predatory intent test would also be difficult to formulate. If it were based on "below cost" pricing it would presumably be generally the case that the subsidy will lead to pricing below the cost of production. Virtually every subsidy would appear to be predatory on such a test. In testing the predatory intent of a subsidy one would have to look to the intent of the government providing the subsidy rather than relying on an objective cost standard. Consequently, formulating a test of predatory intent may also prove to be an insurmountable task. The best alternative solution will depend on the likelihood of predatory subsidies. As noted in Part III above, predation is a strategy with a very low probability of success and is thus an unlikely basis for a subsidy. Thus it may be preferable to drop predation as a basis for the imposition of a countervailing duty.

### 4. *Repeal of Countervailing Duty Legislation*

Since the only cases in which domestic producers would likely be willing to compensate domestic consumers for the imposition of countervailing duties are intermittency and predation, and since these are hard to identify and are unlikely in any case, the repeal of countervailing duty legislation may be considered appropriate.

This idea is based on the gains and losses in the domestic economy. One might ask whether there could be net gains internationally from countervailing duty laws with part of the gain accruing to the domestic economy. It has been argued that international trade benefits from the imposition of countervailing duties, in that countervailing duty laws may discourage the use of deliberate trade distorting subsidies and otherwise neutralize any trade distorting effects of subsidies designed for non-trade domestic policy purposes.<sup>52</sup> Although countervailing duty laws might be justified on this basis, it is not clear that they do in fact neutralize trade distortions. Given the difficulties involved in assessing the amount of the subsidy<sup>53</sup> and the potential for trade distortions due to costly import deterring countervailing duty investigations, countervailing duty laws may create more trade distortions than they neutralize. Further, the administrative process involved in assessing countervailing duties is no doubt a costly one.<sup>54</sup> Thus the repeal of countervailing duty laws would probably not be a removal of a neutralizing mechanism but rather the removal of an administratively costly trade distortion mechanism.

*B. How to Effect Changes in the Face of Dominant Opposing Political Forces*

If the forces that brought about countervailing duty laws are still present how can any of the proposed changes be brought about? For any political forum to bring about such changes as those proposed above it must have two qualities:

- (a) it must weaken the political pressures that favour countervailing duties and/or strengthen the political pressures that oppose countervailing duties; and
- (b) it must be such that, with respect to the adoption of the forum, the strength of the political pressures that favour countervailing duty laws is not sufficient to prevent the adoption of the forum.

To have these two qualities the political forum through which changes can be made must have some combination of four effects sufficient to give the forum the two qualities. The four effects are:

- (a) a reduction of the perceived benefits from promoting or lobbying for countervailing duty laws;
- (b) an increase in the cost of promoting or lobbying for countervailing duty laws;
- (c) an increase in the perceived benefits from opposing or lobbying against countervailing duty laws;
- (d) a reduction in the cost of opposing or lobbying against countervailing duty laws.

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<sup>52</sup> See Sykes, *supra*, note 21 at 256-63.

<sup>53</sup> See C.J. Goetz, L. Granet, & W.F. Schwartz, *The Meaning of 'Subsidy' and 'Injury' in the Countervailing Duty Law* (1986) 6 INTL. REV. OF LAW AND ECON. 17 at 25-26, where the difficulties of calculating the subsidy are noted.

<sup>54</sup> *Ibid.*

Assuming that a change in total benefits and costs for any given degree of lobbying results in a corresponding change in the marginal benefits and costs then these effects should lead to a change in the degree of political influence of opposing political forces.

Two frameworks which hold some hope of achieving a change in countervailing duty legislation are a broad-based set of *GATT* multilateral trade negotiations or a broad-based set of negotiations among a much smaller group (such as bilateral or trilateral trade negotiations).

1. *The Effect of a Broad-Based Set of International Trade Negotiations*

A broad-based international trade negotiating framework would be one in which several trade issues touching on several sectors of the economy are negotiated together such that one country could surrender its position on one issue in exchange for the surrender by one or more other countries of their position on other issues. This is in contrast to a situation where one or a few issues are dealt with such that countries must find common ground on the one issue rather than trading-off gains on one issue against losses on another.

A broad-based international trade negotiating framework is a forum which will tend to have the two above-noted qualities necessary to bringing about changes in countervailing duty laws. Pro-countervailing duty interests will incur higher costs and perceive lower benefits from the promotion of countervailing duty laws. This will be the case not only within the negotiating forum itself but also with respect to the adoption of the forum. Interests opposed to countervailing duties will incur lower costs and perceive greater benefits from opposing countervailing duty laws. This will be the case both with respect to the inclusion of the countervail issue within a broad-based international trade negotiating framework and with respect to opposing countervail within the negotiating framework.

Within a broad-based international trade negotiation the benefits to pro-countervailing duty interests will be reduced. First, domestic producers who produce for the domestic market, and thus benefit from countervailing duty laws, may be willing to accept a reduction in countervailing duty protection in exchange for reduced protection in another country to the extent that they export to that other country. Although these domestic producers would be likely to argue strongly for countervailing duty laws where that narrow issue is raised in a domestic context, they would not perceive the benefits to be as great in an international trade negotiation framework where other benefits can be obtained in exchange for reduced countervail protection.

Further, producers seeking to protect their domestic markets would have to trade off the benefits of various forms of protection they might be able to retain in an international trade agreement dealing with a variety of trade issues. Consequently, there would be a tendency to put

less weight on countervailing duty protection than would be the case if the issue were raised as a separate issue in the domestic political context.

In broad-based international trade negotiations pro-countervail interests will face greater costs than they would in the domestic context. Broad-based international trade negotiations will implicate many more issues than just the question of countervailing duty laws. There will be many more interest groups competing for the attention of those making the decisions with respect to the trade negotiations than there would be in the competition for the attention of those making the decision with respect to countervailing duty laws in the domestic context. This will tend to increase the cost of influencing decision-makers in broad-based international trade negotiations as compared to the cost of influencing decision-makers in the domestic context.

In a broad-based international trade negotiation export-oriented domestic producers will want to obtain reductions in the degree of trade protection in foreign countries to which they export. They will tend to support a reduction in domestic trade protection in exchange for a reduction in foreign country trade protection. Such producers would tend to support a reduction in protection through countervailing duty laws. They would do so because they would perceive significant benefits from reduced foreign trade protection. The perceived benefits of reduced countervail protection are likely to be much greater than if the question of countervailing duty laws is raised at the domestic level. This would be the case since any foreign trade protection response to the introduction of countervailing duty laws at the domestic level and the effect of such response on any given export-oriented domestic producer would be unclear. In other words, the expected benefit from opposing countervail would be less in the domestic context because the probability of a foreign protectionist response affecting the export-oriented domestic producer would be less than it would be in an international trade negotiation framework where countries directly exchange protection reducing concessions.

In summary, in a broad-based set of international trade negotiations, the benefits from promoting countervailing duty laws will tend to be reduced while the costs will tend to be increased. Also, the benefits from opposing countervailing duty laws will tend to be increased. The result will be a reduction in the influence of interests in favour of countervailing duty laws and a greater influence of interests opposed to countervailing duty laws.

One would expect pro-countervail interests to promote the adoption of a forum for dealing with the countervail issues in which their relative influence is strongest. They would be inclined to oppose a forum that weakened their relative influence. One might expect pro-countervail interests to oppose the adoption of a forum such as a broad-based set of international trade negotiations where their relative influence will tend to be reduced. If the forum is to be adopted it must be such that the pro-countervail interests do not dominate in their influence over the choice of forum.

If the government proposes to deal with countervailing duty laws as a separate domestic policy issue then interests opposed to countervailing duty laws will tend not to present much of an opposition to having the issue dealt with in the domestic political context as opposed to some other forum. Their opposition would be weak for much the same reasons that their influence in opposing countervailing duty laws in the domestic political context would be weak. For instance, the benefits that any individual consumer would derive from opposing dealing with the issue as a separate domestic issue would be relatively insignificant. The costs to any individual consumer of opposing the separate domestic issue forum would be high and each consumer would want to hold out against contributing to a fund to cover the costs of opposing the separate domestic issue forum in the hope of getting the benefit without incurring any cost.

On the other hand, if the government proposes to deal with the issue of countervailing duty laws in a broad-based set of international trade negotiations, pro-countervail interests may encounter opposition in an attempt to remove the countervailing duty laws issue from the negotiations. Export-oriented producers would prefer to retain the countervail issue in the negotiations to constrain foreign countries from adopting countervailing duty laws which could be applied against their exports. Export-oriented producers may also want to retain the threat of countervailing duties as a bargaining chip in negotiating for other concessions. In short, the benefits to anti-countervail interests from retaining the broad-based international trade negotiation forum as the forum for dealing with the countervail issue are greater than the benefits from opposing a separate domestic policy issue forum.

The benefits to pro-countervail interests in opposing the broad-based international trade negotiation forum will tend to be less than the benefits from supporting the separate domestic policy issue forum. Domestic producers with substantial export markets, who may well support countervail to protect their domestic markets if it is raised as a separate domestic policy issue, would be willing to accept broad-based international trade negotiations as a forum for the countervail issue in order to get concessions on countervail or other protective measures in their export markets. In other words, the ranks of the pro-countervail interests will be reduced when it comes to opposing a broad-based international trade negotiation forum as opposed to a separate domestic policy issue forum.

In summary, a broad-based international trade negotiation forum has both qualities necessary to achieve a reduction in countervailing duty protection. It can reduce the influence of those in favour of countervailing duty laws while increasing the influence of those opposed to countervailing duty laws. It also weakens the influence of pro-countervail interests in preventing the adoption of the broad-based international trade negotiation forum in which their influence will be reduced.

## 2. *Multilateral GATT Negotiations*

*GATT* negotiations would be a form of broad-based international trade negotiations at which the influence of pro-countervailing interests would tend to be weakened. To have the requisite effect, the issue of countervailing duties would have to be considered not as a separate issue but rather in the context of a broad set of issues being discussed at the negotiations.<sup>55</sup> Countervailing duties might then be dealt with in the context of tariff reductions, quotas, voluntary export restraints, orderly marketing agreements, the generalized system of preferences, currency restrictions and values, or other matters. In such a context countervailing duty protection might be reduced by one country in order to get reduced tariffs, quotas or other forms of protection, including countervailing duties, from another country.

Multilateral *GATT* negotiations could be very effective in reducing the influence of supporters of countervailing duty protection. As the number of countries involved increases, the number of export-oriented domestic producers who would be affected by the trade negotiations would increase. This would occur because when a country is added to the negotiations domestic producers who export to the added country, but do not export to countries already included in the negotiations, would be added to the group of producers seeking reduced foreign trade protection. As the number of countries involved increases and the number of issues at stake increases, the number of domestic interests affected will increase. This will lead to considerable competition for influence over political decision-makers. The result will be that the cost to countervailing duty supporters of influencing the decision-makers will be much greater than it would be in influencing a decision at the domestic level focusing on the enactment or retention of countervailing duty laws. Thus multilateral *GATT* negotiations involving many countries would tend to reduce the political influence of countervailing duty supporters as long as the negotiations involved a broad set of issues.

If a general agreement reducing countervailing duty protection were achieved at the *GATT* level it would be very difficult for countervailing duty supporters to remove the agreement. It would be hard to convince politicians to renegotiate the agreement because it would mean convincing all the countries involved to renegotiate the issue.

The problem with having numerous countries involved in negotiating over a broad set of issues is that the transaction costs of the negotiations are likely to be quite substantial. The number of persons involved in the negotiations, their support staffs, the time involved, the

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<sup>55</sup> Although the Tokyo Round obtained an agreement focusing on the issue of subsidies, the range of issues was probably too narrow to weaken pro-countervailing duty interests. This may have allowed pro-countervailing duty interests to concentrate on influencing those involved in negotiating the subsidies agreement, apparently without having to trade off countervailing duty protection for reductions in other forms of protection in return for similar concessions elsewhere.

difficulties in reducing the details of any agreement to writing, and numerous other complexities will tend to make the cost of the negotiations quite high. More importantly, there are likely to be numerous opportunities for strategic holdout behaviour by parties to the negotiations, with each attempting to extract a better deal for themselves. These problems would make it difficult for agreements to be reached. Consequently, there may be little chance for significant reductions in countervailing duty protection.

### 3. *Bilateral Trade Negotiations*

Bilateral trade negotiations or trade negotiations among a relatively small number of countries could avoid the problem of high transaction costs involved in a broad-based multilateral negotiation at the *GATT* level. Although the complexities of the negotiation and the potential for holdout behaviour would still be present, these problems would not be as significant as they would be where many countries were involved in the negotiations. There is thus a trade-off between the effect of increasing the number of countries and issues on the transaction costs of negotiation on the one hand and the influence of pro-countervailing duty interests on the other hand. Although bilateral negotiations would not be as effective at reducing the influence of pro-countervailing duty interests, the lower transaction costs of bilateral negotiations would make such negotiations more likely to produce an agreement in which the protection afforded by countervailing duty legislation would be significantly reduced.

As trade protection increases, its effect on those who benefit from freer trade may eventually cause them to push for bilateral or trilateral agreements to deal with trade protection where the *GATT* negotiating framework fails. Perhaps in the resulting bilateral or trilateral trade negotiations, countervailing duties will be one of the forms of protection that will be reduced in the context of such negotiations.

#### C. *Implications for Canada-U.S. Negotiations on Subsidies and Countervailing Duties*

On the foregoing analysis the bilateral trade negotiations between the U.S. and Canada, which resulted in the *FTA*, were an approach that had perhaps the greatest likelihood of weakening countervailing duty trade protection. However, the *FTA* did not lead to a modification of existing U.S. and Canadian countervailing duty laws. Instead, the existing domestic country countervailing duty laws will continue to be applied. The only modification is that final determinations of injury in either country can be referred to a binational panel. A Working Group was set up to develop rules on subsidies and countervailing duties.<sup>56</sup>

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<sup>56</sup> *FTA*, Part A, c. 19.



Although the potential to appeal final injury determinations to a binational panel may put the dispute in a political setting in which a finding of injury is less likely, the overall weakening of countervail protection is likely to be quite modest.<sup>57</sup> The dynamics of the situation in Canada and the U.S. probably led to this rather limited weakening of countervail protection. At the time of the negotiations Canada had not imposed any countervailing duties; however, the U.S. had frequently imposed countervailing duties.<sup>58</sup> Although Canadian exporters may have lobbied hard for reduced countervail protection they would not have found support from U.S. exporters to Canada seeking reduced countervail protection in Canada. Countervail protection in Canada, as a practical matter, was virtually non-existent. U.S. exporters would not have perceived a significant threat from Canadian countervail protection. Thus the only force in the U.S. for a reduction in countervail protection would have come from its use as a bargaining chip in exchange for other trade concessions. This may have been a very weak force in the face of U.S. producers who were directly threatened by a loss of countervail protection.

It is unlikely that the efforts of the Working Group established under the *FTA*, Part A, c. 19 will significantly reduce the degree of countervail trade protection. While there will be pressure on the Canadian side to reduce countervail protection,<sup>59</sup> U.S. political forces will lead to staunch opposition to reduced countervail protection.

The Working Group is seized with the narrow issue of subsidies and countervailing duty protection. Thus there will not be an opportunity for the Group to trade off countervailing duty protection with other trade related issues. U.S. domestic producers who benefit from countervail protection can not be placated with other trade protection concessions. U.S. exporters will perceive little benefit in the current Canada-U.S. trading environment from a reduction of Canada's virtually non-existent countervail protection. The only advantage to U.S. exporters of supporting reduced countervail protection would be in return for other trade concessions. This is not possible given the Working Group's narrow focus.

Perhaps the only way in which the political forces may be altered to support reduced countervail protection is if Canadian producers make more use of countervail protection. Then U.S. exporters might join in an effort to reduce countervail protection.

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<sup>57</sup> See T.L. McDorman, *The Dispute Settlement Regime of the Free Trade Agreement* (1988) 2 REV. OF INTL. BUS. LAW 303.

<sup>58</sup> A.M. Rugman & A.D.M. Anderson, *ADMINISTERED PROTECTION IN AMERICA* (London: Croom Helm, 1987) at 21-23.

<sup>59</sup> The sparing use of countervail protection in Canada will mean very few Canadian producers will perceive any significant benefit from retaining countervailing duty protection. Canadian producers who export to the U.S. may perceive substantial benefits from reducing U.S. countervail protection. The net effect will be overall political support in Canada for reduced potential of countervail protection.

## VI. CONCLUSION

An analysis of the gains and losses in the domestic economy due to foreign subsidies suggests that there are net gains to the domestic economy from foreign subsidies and there are consequent net losses from the imposition of countervailing duties. Net gains to the domestic economy from the imposition of countervailing duties may occur where foreign subsidies are predatory or intermittent. However, predatory or intermittent subsidies are unlikely. Countries have nonetheless enacted countervailing duty laws which focus on material injury to domestic producers while ignoring the gains from foreign subsidies. This has probably occurred as a result of the relatively stronger political influence of those that can benefit from countervailing duty laws. If the countervailing duty issue is dealt with in a forum which tends to increase opposition to countervail while decreasing support for countervail, and if the adoption of the forum is not likely to be prevented by pro-countervail interests, it will facilitate a reduction in countervail protection, perhaps through such reforms as a broadening of the injury test, requiring proof of intermittency or predation or the repeal of countervailing duty laws. A broad-based international trade negotiation would be such a forum. The broad-based international trade negotiation probably should involve a relatively small number of countries in order to reduce the transaction costs of reaching an agreement. Such broad-based international trade negotiations should occur in response to pressure from those who would benefit from freer trade. If the countervail issue is dealt with in such negotiations, countervailing duty protection would likely be among the forms of trade protection that are reduced.

The prospects for a lessening of countervail protection as a result of the rules developed by the Working Group established under the *FTA* are slim. The narrow issue on which the Group is focused will lead to a set of political influences which will not be conducive to a reduction of countervail protection.