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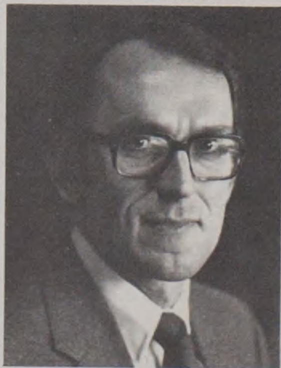
MONTANA BUSINESS QUARTERLY

Volume 26, Number 2 Summer 1988

The Forest Products Industry and Community Stability

Polzin named BBER director



Paul E. Polzin

Paul Polzin has been chosen director of the University of Montana's Bureau of Business and Economic Research.

Polzin, who assumed his new duties May 1, is a management professor who has been a research associate with the Bureau since 1968 and its director of economic forecasting since 1983. He replaces Maxine Johnson, who retired as Bureau director Feb. 5.

Polzin specializes in regional economics and applied econometrics. He was a consulting research economist with the U.S. Forest Service from 1972 to 1977 and continues to work closely with that agency on issues relating to natural resources and the economy.

He earned a doctorate and a master's degree in economics at Michigan State University in 1968 and in 1964 received a bachelor's in that field at The University of Michigan.

A fifteen-person committee made up of UM, state and local government, and private industry representatives chose Polzin Bureau director. He was one of three finalists in a national search.

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The *Montana Business Quarterly,* (ISSN 0026-9921) is published in March, June, September and December of each year by the Bureau of Business and Economic Research, and is a service of the University of Montana, Missoula. The subscription rates for the *Quarterly* are $15.00 per year, $25.00 for two years, $35.00 for three years, and $4.00 per issue. Second class postage paid at Missoula, MT 59812. POSTMASTER: Send address changes to the *Montana Business Quarterly,* Bureau of Business and Economic Research, University of Montana, Missoula, MT 59812.

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Reprints of the articles are not available but additional copies of the *Quarterly* can be secured at $4.00 per copy.

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Montana Business Quarterly
Bureau of Business and
Economic Research
University of Montana
Missoula, MT 59812

2750—UM Printing Services

The Forest Products Industry and Community Stability: The Evolution of the Issue

CON H SCHALLAU

Over forty years have passed since Congress gave the Forest Service specific guidelines for considering community stability in setting its policies. Federal officials obviously recognized that a change in the availability of federal timber could seriously impact those rural areas whose economies are based primarily on the wood products industry. Western Montana is certainly an example of a timber-dependent region.

While the Forest Service must consider the issue of community stability, Congress has never defined its meaning. What factors comprise community stability? How are they measured? Forest Service officials are still wrestling with this issue. Forest Service critics complicate the matter by demanding changes in Forest Service policies or practices, changes that could affect community stability.

As a result, the topic of community stability remains a vexing issue. How can the Forest Service respond to the needs of the timber industry and the public pressures of environmentalists, while at the same time wisely managing the federal forests and ensuring stability in those communities who depend on the timber industry as a major source of jobs? Con Schallau, a respected Forest Service economist, has been studying the issue for several years. This article, an update on the evolution of the community stability issue, is based on a presentation he made in November 1987 to the National Conference on Community Stability in Forest-Based Economies, held in Portland.

Earlier this year, I had the opportunity to discuss community stability. The title assigned to me was "Community Stability—Orthodoxy vs. Reality." It was "mission impossible," because, despite all the writing and rhetoric, there is no consensus regarding the issue of community stability. Had I chosen a title, it would have been "Community Stability—in Reality, There Is No Orthodoxy."

Others have described the lack of consensus regarding the issue of community stability. In December 1986, for example, *High Country News* featured an article by George Sibley about the Shelton (Washington) Cooperative Sustained Yield Unit. When the Shelton Unit was created in 1946, the Simpson Timber Company was given exclusive harvesting rights for 100 years to 113,000 acres of virgin Douglas-fir and hemlock timber on the Olympic National Forest. In exchange, Simpson had to commit some of its remaining old growth plus cutover lands — 237,000 acres total—to sustained-yield management to help stabilize employment in the communities of Shelton and McCleary, Washington.

In his article, "The America That Did Not Happen," Sibley noted:

> ... "stabilization" is another one of those tricky words—a word that, like Humpty-Dumpty said to Alice, "means just what I choose it to mean—neither more nor less." Any effort to derive an operational definition of "stabilization" out of the agreement leads one to the conclusion that the word didn't mean very much at all to either Simpson, the Forest Service or the people of the region.

Although I agree with Sibley that stabilization can be interpreted in many ways, I do not agree that the word did not mean very much. The Great Depression was fresh in the minds of the cosigners when the Shelton Unit was established in 1946. Furthermore, it was common knowledge that Simpson, like other private forest landowners in the Puget Sound area, was about to run out of mature timber. One did not have to use much imagination to know what could happen to the Shelton and McCleary economies if timber harvesting from public forest land was not accelerated.

Today, the future of many other timber-dependent communities in the nonmetropolitan West resembles the situation facing Shelton, Washington, after World War II. Short of unprecedented success in achieving economic diversification, communities will experience hard times. Unless, of course, additional timber supplies become available. This is why the subject of community stability—whatever it means—has attracted so much attention.

Community stability cannot be understood without a sense of history. Consequently, I will begin with a review of how this concept evolved as a forestry issue.

Like a ship at sea, the concept of community stability has accumulated a lot of barnacles and needs a new coat of paint. I will examine how we got here. Along the way I will pay particular attention to some nagging questions—barnacles and oxidized paint, so to speak—that impede progress.

To begin, let us consider where community stability fits into the hierarchy of USDA Forest Service goals. Of critical importance is the question, "Which is more important, sustained yield or community stability?"

"Despite a lack of consensus, I believe most observers can grasp how community stability, like sustained yield, can be a means to achieving satisfaction and well-being."

Which is more important, sustained yield or community stability?

The spectre of stranded communities in cutover areas of the Great Lake states attracted considerable attention (Sparhawk and Brush 1929). Nevertheless, Congress did not enact explicit direction to assure community stability until nearly fifty years after the National Forest System was established in 1897.

Because of abundant timber on private lands, demand for public stumpage was practically nonexistent until after World War II. The Forest Service could not affect the economic development of timber-dependent communities until it became a significant force in the market place for timber products; there was no need for Congress to intervene in the name of community stability.

Although community stability was not an early policy issue, sustained yield was. The fear of a future timber famine led to the concept of sustained yield (that is, to provide for "a continuous supply of timber") contained in the 1897 Organic Act.

During the 1920s, industry representatives in the Pacific Northwest were concerned that premature harvesting on national forest lands would disrupt the market for their stumpage. Strangely enough, it was the oversupply of private timber that fostered sustained-yield management on public forests in the West.

The late David T. Mason is generally regarded as the granddaddy of the nation's concept of sustained yield. Mason (1927) envisioned sustained-yield management as a means for reducing the availability of timber in the Pacific Northwest and thereby discouraging lumber companies in the South from moving to the West. In its barest form, Mason's concept would have served to restrain entry into the forest products industry in the Pacific Northwest.

The Great Depression postponed official adoption of Mason's sustained-yield concept. Although timber harvesting in the National Forest was minimal, the sale of timber was temporarily halted to minimize problems for the private sector. Although the secretary of the interior was authorized in 1937 to establish sustained-yield units for the support of dependent communities and local industries, no units were established until after World War II (Dana 1956).

Decisions regarding custodial activities—in contrast to timber harvesting—had little or no effect on the economic performance of timber-dependent communities. Consequently, the National Forest System played a passive role as far as community stability was concerned.

This passive role ended with the passage of the Sustained Yield Forest Management Act of 1944 (53 Stat. 132). This act authorized the secretaries of agriculture and the interior to establish either (1) cooperative sustained-yield units requiring both public and private forest land, or (2) federal sustained-yield units consisting only of federal land to "promote the stability of forest industries, of employment, of communities and taxable forest wealth, through continuous supplies of timber." The Shelton cooperative unit on the Olympic National Forest and five federal units elsewhere in the West resulted from this act. Of the latter, only the Lakeview (in Oregon), Big Valley (in California), and the Grays Harbor (in Washington) remain active.

No cooperative units or federal sustained-yield units were established by the Department of the Interior. In 1946 and 1947, however, the secretary established twelve marketing areas consisting of Oregon and California (O&C) lands in western Oregon, "the product of which should logically go to definite marketing areas" (Dana 1956). These marketing areas were abolished in April 1959.

The establishment of the O&C master units and the cooperative and federal sustained-yield units comprised of national forest lands represents the high water mark as far as community stability policies are concerned. In the ensuing twenty to twenty-five years, concern for community stability waned. The Forest Service shifted its rationale for sustained yield from community stability to "conservation of resources to help meet the wants of future generations" (Josephson 1976).

As Waggener (1977) predicted, the enactment of the National Forest Management Act (NFMA) of 1976 sparked renewed interest in the issue of community stability. For example, the greatest interest expressed in public responses to draft regulations, developed pursuant to the NFMA, concerned proposed changes in nondeclining even-flow timber harvest policy. More recently, below-cost timber sales have been rationalized in the name of community stability. Whether this renewed interest will help timber-dependent communities in the Pacific Northwest achieve economic stability remains to be seen, however.

Despite a lack of consensus, I believe most observers can grasp how community stability, like sustained yield, can be a means to achieving satisfaction and well-being. But these policies may be mutually exclusive. If so, which is more important? Congress is responsible for the answer to this question, but to date, unfortunately, its actions have done more to obfuscate than to clarify the question (Schallau and Alston 1987).

In the meantime, the Forest Service has, at least implicitly, provided its own ranking of the community stability and sustained-yield goals. Acting to prevent the possibility of a shortfall in timber production that had been forecast in the Douglas-fir Supply Study (USDA Forest Service 1969), the Forest Service issued an emergency directive that spelled out the now famous nondeclining even-flow policy (USDA Forest Service 1973).

Implementing the nondeclining cut policy caused an immediate reduction in the programmed harvests from the national forests in the Pacific Northwest. The former policy would have postponed a significant shortfall in the allowable cut for ninety to 120

"I find it hard to accept the notion that a single, uniformly applied scenario for scheduling timber harvesting will promote . . . stability for all timber-dependent communities."

years. It could be argued that, had the Forest Service been more committed to economic stability, they would have adopted an alternative scenario and thereby postponed the decline to allow the communities sufficient time to adjust. The choice of going with the nondeclining even-flow policy may imply that the Forest Service ranks sustained yield ahead of community stability. Or does it? It all depends on the answer to the next question.

How is community stability achieved?

The Code of Federal Regulations describes the "Disposal of national forest timber according to management plans." This code states that management plans shall "be based on the principle of sustained yield . . ." and "provide . . . an even flow of national forest timber in order to facilitate the stabilization of communities and of opportunities for employment." This code suggests that community stability will be achieved by an even-flow timber harvesting policy.

I find it hard to accept the notion that a single, uniformly applied scenario for scheduling timber harvesting will promote economic stability for all timber-dependent communities. To do so presumes that all communities have the same economic future. A more logical policy would recognize the possibility that some communities are beyond help; some communities do not need help; and others might benefit from a departure scenario. I do not see how we can fashion a reasonable policy without a way to identify communities that might benefit from a departure scenario. In the interest of finding a community stability indicator, I would like to share my "economic coercion" hypothesis.

Community stability exists if all the following questions can be answered with a "yes":

- Did the majority of persons moving to a community within the last decade perceive that by doing so they were able to maintain their permanent income?[1]
- Did the majority of persons moving from a community within the last decade perceive that by doing so they were able to maintain their permanent income?
- Do the majority of persons choosing to remain in a community perceive that by doing so they are able to maintain their permanent income?

A majority of "no" answers would, I hypothesize, indicate that all is not well in Timber Town, USA.

Although I have no theoretical proof, I do have anecdotal evidence that my hypothesis might help determine if a community is stable. For example, on April 1, 1987, the Corvallis, Oregon *Gazette Times* carried the following statement by Dale Romrell (1987): "...I would like to see Corvallis prosper enough so someday I could sell my house easily." Furthermore, I asked my barber if he sympathized with Romrell. He did, and added that he would also like to be able to sell his business. He did not want to be the last guy out of town.

Has community stability acquired economic standing?

Phyllis Austin, writing in the August 1987 issue of *Forest Watch* states that, "The typical forest industry CEO isn't worried about harvesting trees but about policy and finance issues...." She goes on to decry corporate raiders who "have 'accelerated harvest on their minds' to increase profits, at the expense of the forest."

Ironically, the August 1987 issue of the *Journal of Forestry* featured articles about "below-cost" timber sales. If you have been following this issue, you know that the Forest Service has been criticized for not recovering all costs associated with its timber sales program. So what should be done—does the Forest Service accept or reject the emphasis on the bottom line? Needless to say, critics cannot have it both ways!

As we all know, Congress rejected the bottom line mentality when it intervened and created the National Forest System to assure a perpetual supply of timber. As a result, we have a public goods-and-services-producing institution that defies the fundamental assumptions of mainstream economic analysis. Furthermore most policy issues—including community stability—have resulted because Congress has not put limits on how far the Forest Service can deviate from the bottom-line mentality of the market place.

Mainstream economic theory (that is, neoclassical theory) presumes that maximization of profits is the fundamental criterion. Since profit-making, per se, is not the objective of the National Forest System, the existence of the National Forest System cannot be rationalized by conventional theory. On the contrary, the Sagebrush Rebellion was, in part, the brain child of economists who used neoclassical economics to justify privatizing the National Forest System.

So where does community stability fit in? Does it have economic standing? In its strictest form, conventional theory assumes a market economy with perfect competition between buyers and sellers. That is, no trader can influence prices, and excess profits will not persist because new firms are free to enter the industry. In fact, however, private firms cannot enter the log-supplying business throughout much of the West because Uncle Sam holds most of the remaining inventory.

Neoclassical theory also assumes that market forces will maintain full employment. Persistent unemployment, if it exists at all, is assumed to be voluntary. Instability in the marketplace will be of short

[1]*According to Pearce (1983), permanent income is "the average income that the individual or household expects to receive over a period of years."*

". . . the selling of "cheap" stumpage might represent implicit compensation to the processing industry for the monopoly rents earned elsewhere by the Forest Service."

duration and will be self-correcting. As far as conventional economic theory is concerned, therefore, community stability is an irrelevant issue.

In fact, labor and capital are not perfectly mobile. Furthermore, voluntary unemployment is not commonplace, and labor and capital are often frozen in place. A community stability policy—however described—may not be necessary, but the question of how to achieve economic stability has standing in some economic circles. How else do you explain the development of Keynesian economics?

Let us not toss out the baby with the bath water. Just because the fundamental assumptions of mainstream economic theory do not represent reality is no reason to ignore the usefulness of the tools of economic analysis. Let me illustrate by considering the following question.

Is the USDA Forest Service subsidizing the forest products industry?

An increasing number of processors in the West depend on national forests for all of their timber. In such instances, the Forest Service is a monopolist. Economic theory says that a monopolist maximizes profits by supplying less product than it would have to in a competitive market. Restricting supply would result in higher prices and, consequently, higher profits—all to the detriment of society at large.

Hagenstein and others (1987) analyzed the timber harvesting policies of the Forest Service in the Pacific Northwest and found the Forest Service behaving like a monopolist. They compared annual timber harvest and prices for current nondeclining even-flow ("baseline") policies with those that would be obtained if a truly competitive market for logs existed. They found that

> projected prices for stumpage in constant dollars on the Westside (western Washington and Oregon) for the 1980s were 81 percent below the baseline forecast, and those on the Eastside (eastern Washington and Oregon and all of Idaho) were 72 percent lower.

Furthermore, they estimated that if current public timber-harvest policies prevail during the 1980s and 1990s, about $4 billion of income annually will be shifted from individual consumers of forest products and the timber-processing industry to public and other timber owners in the Northwest.

Critics of the below-cost timber sale policies have accused the Forest Service of subsidizing the forest products industry in the name of community stability (Wilkinson 1985). By themselves, individual below-cost sales might well be described as a subsidy. Considered in a global sense, however, the selling of "cheap" stumpage might represent implicit compensation to the processing industry for the monopoly rents earned elsewhere by the Forest Service.

What will take the place of the forest products industry?

The nation's leaders are struggling to find ways to reenergize our economy. The challenge is particularly acute for small towns and rural areas where forest resources are abundant, for example, in the Pacific Northwest. In the seven years between 1978 and 1985, Oregon's per capita income slipped from better than the national average to 91 percent of the national average—its lowest in fifty-five years—and the gap is widening.[2]

Washington's economy is faring better, thanks mainly to the U. S. defense buildup during the last seven years, but a slowdown in defense spending would damage the economy considerably. Besides, the economic plight of rural areas in Washington resembles that of their counterparts in Oregon (Coit 1987).

Traditionally, most new jobs are created by small, usually existing businesses. Few communities stand a chance of attracting a new, large employer. Consequently, retention of existing firms is of prime importance. Nevertheless, diversification is an appropriate long-term goal for some timber-dependent communities. But this process is slow and fraught with pitfalls and dependent on a viable public and private infrastructure. Traditionally, the infrastructure has been supported by timber.

Tourism and recreation are often touted as the solution to ailing forest-resource-based communities. They may be the solution, but only in isolated situations where four-season facilities and entertainment can be provided. Lake Tahoe, Nevada/California; Sun Valley, Idaho; and Bend, Oregon are familiar examples. Otherwise, tourism and recreation are adjuncts to existing industries that provide year-round employment.

A remote, stand-alone resort complex that attracts seasonal use may generate substantial cash flow and still not bolster the surrounding economy. Rajender and others (1967) encountered this phenomenon in their study of the economy of Teton County, Wyoming. Referring to the "leakage" from the county, they point out that

> there is a complicating factor in that many of the summer residents are seasonal workers who have a permanent residence elsewhere. These people are inclined to spend relatively little money during their residence in the county; the bulk of their earnings goes into expenditures at their regular place of residence.

In fact, they observed that, because of this leakage of funds, the multiplier effect actually declined over a five-year period.

Closer to home, we simulated the job loss associated with the projected shortfall in timber harvesting from

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[2] *According to J. Cartright, losing ground is the growing gap between Oregon and national income. Unpublished staff report to the Joint Legislative Committee on Trade and Development. 1986. Salem, OR.*

"*. . . the Japanese are trying desperately to retain their manufacturing capability to avoid the mistakes that caused industrial decline in the United States. . . .*"

public and private forest lands in western Oregon (Olson, Schallau and Maki 1988). We examined the cumulative employment effects of a hypothetical 20 percent reduction in harvesting from the national forests and the shortfall in harvesting from forest industry lands projected by Beuter and others (1976).

We used growth rates provided by the U.S. Department of Commerce for each of the seventy-five industries in our representation of the Oregon economy. We also allowed for technological changes in all industries including the forest products industry.

Our simulation showed that the economy of western Oregon will continue to grow in spite of a shortfall in timber harvesting. But the difference—the impact—between the baseline scenario and the scenario with the shortfall is substantial. Furthermore, our simulation suggests that despite continued growth of all nontimber-related industries—agriculture, high-tech, tourism, transportation, wholesale and retail trade—the state's economy will need an extraordinary and sustained shot in the arm to overcome the effects of the shortfall in timber harvesting.

Does the forest products industry matter?

Thirty years ago, John Kenneth Galbraith (1958) had this to say about our affluent society:

> ...The greatest prospect that we face—indeed what must now be counted one of the central economic goals of our society—is to eliminate toil as a required economic institution. This is not a utopian vision. We are already well on the way. Only an extraordinary elaborate exercise in social camouflage has kept us from seeing what has been happening.

Within a decade, many observers began to share Galbraith's concern. For instance, in 1973, Daniel Bell popularized the notion that the United States should shed the sunset industries of the past—that is, heavy industries—and welcome the sunrise sectors of the future, namely services and high tech. We had become a "post-industrial" society and the sooner we recognized this metamorphosis, the better off we would be!

The notion of the post-industrial society is embraced by those in high places. In his 1985 annual report on trade agreements programs, President Reagan (1985) had this to say:

> The move from an industrial society toward a "post-industrial" service economy has been one of the greatest changes to affect the developed world since the Industrial Revolution. The progression of an economy such as America's from agriculture to manufacturing to services is a natural change.

According to a spokesperson for the New York Stock Exchange (Seligman 1987), "a strong manufacturing sector is not a requisite for a prosperous economy." Then there is Malcolm Forbes who stated (Cohen and Zysman 1987):

> Instead of ringing in the decline of our economic power, a service-driven economy signals the most advanced stage of economic development . . . . Instead of following the Pied Piper of "reindustrialization," the U.S. should be concentrating its efforts on strengthening its services.

Events of the recent past—the recession of 1981 and 1982, declining industrial productivity, trade and budget deficits, and of course, the stock market crash of this past October—have had a sobering effect. We have become more cautious and introspective as Japan continues to assert its economic power.

Many industrial observers are expressing concern about the growing tendency toward offshore manufacturing—the hollowing of our economy. The fear is that offshore manufacturing will result in the loss of onshore control (Cohen and Zysman 1987). The fact that the Japanese are trying desperately to retain their manufacturing capability to avoid the mistakes that caused industrial decline in the United States should, according to some business analysts, stir us into action (Borrus and Holstein 1987).

In a recent essay, "Road from Constantinople," Sudia (1987) described Wallerstein's world system hypothesis. This hypothesis would have increasing amounts of U.S. capital seeking more lucrative ventures in foreign capitals. If this process has merit, New York will relinquish its role as the world's financial capital by the middle of the next century. Sudia thinks the United States has a chance to survive challenges to its economic authority, but "if we pursue the beef and citrus markets in Japan—if U.S. capital goes to Japan—we will be just another country on the road from Constantinople."

Perhaps the most forceful challenge to the legitimacy of the concept of the post-industrial economy has been provided by Stephen S. Cohen and John Zysman, two academicians at the University of California at Berkeley's Roundtable on the International Economy (BRIE). They claim that we do not now have a post-industrial economy, and we had better not acquire one. In their recent book, *Manufacturing Matters: the Myth of the Post-industrial Economy,* Cohen and Zysman (1987) state

> Rather than an element and sign of economic development, much of the growth of service employment may be a way of spreading around economic stagnation, as we all take in each other's linen for wash or, at least, each other's relatives for care.

Any student of economic growth theory will appreciate Cohen and Zysman's emphasis on productivity and how strongly linked it is to a nation's standard of living: "America's preeminent wealth and power is based on American productivity being higher than that elsewhere." How can one logically presume that a shift to

"In the future, how we as a nation regard the role of manufacturing will . . . determine how well the forest products industry and dependent communities prosper."

services—where growth in productivity has stagnated—will allow the United States to maintain its standard of living?

Cohen and Zysman's basic premise is that the United States not only will suffer a decline in its standard of living but also will lose out as an economic power if it keeps losing key industries that foster the change and expansion of other industries:

> ...if we lose mastery and control of manufacturing, the high-paying service jobs that are directly linked to manufacturing will, in a few short rounds of product and process innovation, seem to wither away (only to spout up offshore, where the manufacturing went).
>
> It is the high-value-added service roles tied directly to manufacturing (whether they are located in service or manufacturing categories) that we must hold and develop if we are to remain a powerful economy. It is not manufacturing jobs per se. In brief, in order for the shift of employment to services to be developmental and not become a shift to poverty, we must maintain mastery and control of manufacturing production.

Conclusion

So what does this have to do with community stability? Cohen and Zysman (1987) assert that many old-line industries have a transitional role—to promote the development of state-of-the-art equipment and more efficient production to meet foreign competition. In this regard, I believe the forest products industry and dependent communities can play a role.

The ability of the United States to compete well in foreign markets is on the national agenda. Policies influencing our nation's industrial strength will be shaped by Congress. This does not mean that such policies will be created without regard for the role that individual industries play in maintaining our economic prowess.

In the future, how we as a nation regard the role of manufacturing will, to a considerable degree, determine how well the forest products industry and dependent communities prosper. I believe that recognition of the serious challenge to U.S. competitiveness should have a bearing on how the community stability issue is resolved. I agree with Cohen and Zysman (1987) that we must "avoid the idiocies that result when we make domestic policy as if our internal choices had no consequences in international markets . . . [and] we must link domestic policy to international policy in a more positive way."

In the same vein, I would add that we must avoid the idiocies that result when we disregard the cumulative economic effect of the policies of private forest landowners as if their contribution had no bearing on the future of dependent communities.

I believe we must avoid the idiocies that result when we disregard the monopoly profits earned by the Forest Service in the Pacific Northwest as if their existence had no bearing on the economic evaluation of below-cost timber sales.

Finally, I believe we must avoid the idiocies that result when we make community-stability policy as if our choices had no consequences in regional and national markets. □

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The U.S. - Canada Free Trade Agreement: Implications for Montana

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The United States and Canada have the most extensive trade relationship in the world. But despite the unmatched flows of goods and services across the border, significant barriers to trade between the two countries remain. Negotiations toward a comprehensive bilateral free trade agreement (FTA) were initiated in May 1986, and concluded in October 1987. President Reagan and Prime Minister Mulroney formally signed the agreement on January 2, 1988.

Neither country achieved all of its objectives in the negotiation. Nevertheless, the FTA is a remarkable document. Ratification would create the world's largest free trade area, a continental market of 265 million people. Both the Reagan administration and the Mulroney government have hailed the FTA as a historic accomplishment in U.S.-Canada relations and a "win-win situation," meaning the benefits to both countries outweigh the costs. Their optimism is predicated on the expectation of net increases in economic growth and employment in both countries, enhanced security for investors, improved market access for exporters, lower prices for consumers and mitigation of trade disputes before they become costly.

The Agreement's Provisions

The main features of the FTA deal with transborder transactions, national treatment, and the handling of trade disputes.

Transborder transactions

The most important elements of the agreement include the removal of tariffs, the lifting of certain quantitative and qualitative restrictions, and the easing of regulations on border crossings for business purposes.

Tariffs. The agreement calls for the elimination of all tariffs and establishes a staging process whereby certain tariffs would be removed immediately, others after five years, and the rest at the end of ten years.

Quantitative and qualitative restrictions. Quotas, embargoes and minimum price requirements to restrict trade will not be allowed, except in accordance with the rules of the General Agreement on Tariffs and Trade (GATT) rules, which permit measures for health, safety, security, conservation and short supply. Export restrictions based on conservation needs may be taken, but they must provide for the sharing of the resource with the other party and must not create price discrimination by other means.

Exit, entry, and customs restrictions. Certain immigration laws and customs procedures inhibit business transactions. Investors and professional service providers, such as architects, engineers and consultants, have been held up at the border by red tape. Personnel from export firms have had trouble crossing the border to perform maintenance, warranty, and other after-sales services on commercial or industrial equipment. The FTA establishes a list of qualified business persons who will be able to cross the border for temporary stays under special visa classification.

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National treatment

Important provisions of the FTA are based on the internationally recognized principle of national treatment, whereby foreign commercial entities are treated in a non-discriminating fashion, as if they were domestic firms.

Financial services. The agreement on financial services is a self-contained component of the FTA, to be administered by the U.S. Treasury Department. It removes essentially all existing discrimination faced by U.S. financial institutions operating in Canada, allows the flexibility to acquire Canadian financial services firms, and allows financial firms on both sides of the border to compete on a more equal basis.

Investment. The investment portion of the FTA provides reciprocal guarantees against discriminatory barriers and regulations that can threaten the security of transborder capital flows. United States investors wishing to directly purchase Canadian firms valued at less than $150 million in Canadian dollars will not require approval from Canadian investment screening authorities. Indirect acquisitions, involving Canadian subsidiaries of acquired foreign parent companies, will no longer be screened after a phase-out period.

Government procurement. The U.S. and Canadian governments apply various "buy national" preferences to favor domestic goods and services. These preferences inhibit competition from foreign producers. Under the FTA, suppliers of goods that are manufactured in the United States or Canada and which contain at least 50 percent U.S. or Canadian content will be treated on an equal basis to suppliers of domestic goods for covered procurements.

Services. The Canada-U.S. FTA is the first international agreement governing trade and investment in services industries. The FTA commits both countries to work toward mutual recognition of licensing and certification requirements in areas not already covered by reciprocal agreements. Future requirements for individuals providing services, such as accountants and engineers, will be based on competence, not nationality.

Standards. Product and labor standards sometimes inhibit bilateral trade. Notwithstanding legitimate public policy goals for which technical regulations and standards are maintained (e.g., to protect human, animal or plant life or health, to preserve the environment, and to protect security interests), some standards-related measures hinder trade unnecessarily. The FTA obligates both countries to harmonize federal-level standards to the greatest extent possible, and to promote the harmonization of private standards.

Dispute settlement

Fashioning an effective mechanism to settle trade disputes was a major Canadian objective in the negotiations. Most bilateral trade is conducted on friendly terms, so the new method of resolving disputes will probably affect a relatively small proportion of total bilateral exchange. Still, conflicts have arisen in recent years over goods of enormous value to one or both countries. Since frequently resorting to protective and retaliatory "trade remedies" can eliminate the benefits of free trade, a Canada-U.S. Trade Commission would be created to help avoid and mitigate such problems.

Countervail and antidumping actions. Each country will continue unilaterally to administer and enforce its countervailing duty and antidumping statutes. However, special binational dispute settlement panels can review whether final administrative decisions are appropriate under national laws. The FTA thus creates a binational mechanism that replaces judicial review of decisions taken by the U.S. International Trade Commission, the U.S. Department of Commerce, and their counterpart agencies in Canada. Panel decisions will be binding, so petitioners will no longer have recourse to national courts, such as the U.S. International Trade Court.

Safeguards. The FTA provides for a safeguard system that parallels Section 201 of the Trade Act of 1974—also known as the "escape clause"—to preserve the rights of workers and firms in both countries to gain relief from import-related injury. While the United States and Canada have not used safeguard actions against each other very often, the possibility of doing so reduces the certainty of market access. Rules on the use of safeguard actions need to be included in the FTA to facilitate corporate planning.

Unfinished business: non-tariff barriers

The FTA is not comprehensive; certain industries and specific items were either excluded from the agenda or dropped from the text at various stages of the negotiations. Some of the products not covered by the agreement, such as steel and lumber, are expected to be handled by separate negotiations (although these items may later fall under the purview of the dispute settlement mechanism). In other sectors, stiff and well-organized opposition to prospective features of the FTA compelled trade officials to explicitly exempt some types of trade and simply ignore others.

Many non-tariff measures are not covered by the FTA. Both national governments employ a variety of incentive and equalization programs that appear to give certain industries an advantage in some export markets. Proponents of a truly comprehensive trade agreement were also compelled, in the end, to acknowledge the political and administrative difficulties of fashioning an accord that would legally bind provinces and states without fomenting constitutional challenges.

Several policies at the national level can be construed as unfair trade practices. One example is building codes that may require a higher level of construction quality for imports. Another is transportation practices, which can entail direct subsidies to move certain products or indirect subsidies in the form of requirements

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that shipments in domestic waters must be made on domestic carriers. Another example, in Canada, is the use of state trading agencies such as the Canadian Wheat Board.

With one clear exception—the treatment of wine imported to Canada from the United States—the FTA does not extend into areas of provincial jurisdiction. It also does not appear to alter or nullify the various powers of state governments to regulate commerce within their boundaries. States maintain "Buy American" clauses in rules governing contract awards for some types of construction and maintenance projects. Other examples of non-tariff barriers that the FTA does not eliminate include: state and provincial farm support; special tax and public sector financial incentives; direct loans and loan guarantees to small and medium-sized businesses; state regulations restricting foreign ownership of insurance and banking firms, or farmland; and other promotional and support services provided to exporters.

Terms of abrogation

Either country can withdraw from the FTA after giving the other six months' notice of intent. In addition, if an agreement on a new bilateral regime for trade remedies laws is not reached after the seven-year period specified in the dispute settlement provisions, either country could terminate the agreement. This feature provides a legal means of escape from obligations that do not lead to anticipated benefits (Office of the U.S. Trade Representative 1988).

Gains from Trade in Theory

Economic theory and the experience of western trading nations strongly indicate that the gains from freer trade outweigh the losses, usually referred to as the costs of adjustment. In general, trade liberalization leads to greater economic efficiency, productivity, and growth, which, in turn, generate increased employment and higher incomes and result in more stable prices and lower interest rates. Greater efficiencies are realized through specialization, larger production runs, and other economies of scale.

The reduction or elimination of tariff and non-tariff barriers lowers consumer prices, increases consumer choice, and raises the quality and availability of goods and services. Benefits to industry include market expansion, lower input costs, greater opportunities for product diversification, and lower risks to investors in export-oriented firms. In the long run, freer trade, because it appears to stimulate growth, can also lead to import substitution as small domestic firms seize opportunities to supply the larger companies engaged in trade.

All of these points apply to the United States and Canada. Closer analysis, mainly by Canadian economists, has yielded positive (if wide-ranging) calculations of net growth in Gross National Product (GNP) resulting from a bilateral free trade accord (Whaley 1985). The net effects of gradual but substantial tariff reductions appear modest but the benefits are nonetheless real: even a 1 or 2 percent rise in U.S. GNP translates into substantial employment benefits. In the U.S., each $1 billion in trade is associated with approximately 25,000 jobs (U.S. Department of Commerce 1986).

The gain for Canada is expected to be greater because small countries benefit the most—via economies of scale and market access—from closer integration with larger ones. Both countries should enjoy some benefit from trade diversion. Each country can save money by buying goods in North America, goods that might otherwise have been purchased from overseas suppliers where tariffs would still apply (Wonnacott 1987).

Another significant benefit to both countries is the enhanced security of investments that would result from a formal trade agreement. This may be as important to Canada, in the long run, as gaining more secure access to U.S. markets for Canadian exports. United States firms are also more likely to expand their operations in Canada because the trade agreement substantially reduces the likelihood of any future discriminatory actions similar to the National Energy Policy and the restrictive practices of the Foreign Investment Review Agency in the 1970s. Since Canada ranks third as a source of direct foreign investment in the United States, and such investments have increased dramatically in recent years, the reciprocal security provided by the agreement is an important benefit to those sectors of the U.S. economy reliant on Canadian capital for expansion.

Estimates of the effects of bilateral free trade rest on assumptions about increased specialization, higher productivity, trends in the labor market and the realization of economies of scale in key sectors. These aggregate expectations are, in turn, based on the assumption that individual firms will behave in an economically rational manner if barriers to trade are removed. Thus, the gains from freer trade are predicated on business decisions that are perhaps more free from nationalistic and other non-commercial motivations than can be reasonably expected. Free trade creates opportunities, but cannot guarantee that companies will seize them.

"Montana . . . has a small material stake in Canadian trade. . . . The exceptions, however, are important."

Trade and Investment Patterns: Montana and Canada

A free trade agreement with Canada will have important effects, but the agreement will have a marginal effect on this country's overall economic performance. Increased trade is no panacea for persistent, deeply-rooted economic problems. Montana—compared to other border states such as Michigan, Minnesota, and Washington and to high population and rapid growth states in the West like California, Texas, and Colorado—has a small material stake in Canadian trade. Montana's geography and resource base are very similar to those of neighboring Canadian provinces. But lacking a comparable population, there are few obvious reasons for extensive trade to take place, especially in the raw and semi-processed commodities such as grain, coal, and lumber that all possess in abundance. The exceptions, however, are important.

The bulk of Montana's trade with western Canada is in similar products: chemicals, cattle, fertilizers, drilling machinery, agricultural equipment, and some wood products travel both ways across the border. This trade resembles the bilateral pattern, where much of the $150 billion exchange is in similar goods and services. Comparative advantage applies to the movement of phosphates and non-metallic minerals north (that Montana can produce at relatively low cost) and in crude oil and natural gas transfers to the south (mainly from Alberta, which has large reserves of both). Trade in crude materials is still important, reflecting the dearth of processing facilities on either side of the border. Phosphate rock, for example, is shipped to Canada to be made into fertilizer; mineral concentrates are sent to Montana to be broken down into more refined products.

The balance of trade between Montana and the neighboring provinces seems lopsided in Canada's favor. In 1986, Montana exported approximately $89 million worth of commodities to Canada and imported $512 million (Office of Canada 1988). Most of the estimated $423 million "deficit" is a result of the relative economic power and export orientation of the western provinces and U.S.-Canada exchange rates. Regional balance of trade figures, like the more familiar national ones, do not show interest and dividend payments, service expenditures and tourism revenues flowing in both directions. So, the overall "balance of payments" could tip the scale toward transborder parity.

In addition, the best available statistics, which come from Canada, do not distinguish between goods shipped to and from Montana, and those transiting the state. More significantly, trade flow data cannot show the economic benefits of imports. Montana refineries, for example, rely upon Canadian crude for about one-third of their oil supply. Nearly three-fourths of Montana's trade deficit with Canada is attributable to imports of this raw product to which value is added in the state.

Montana ranked seventh out of ten western states in terms of employment generated by Canadian direct investment. Canadian companies were responsible for $963 million worth of investment, directly employing over 1,200 Montana workers in 1987 (Office of Canada 1988). This proportion may be even greater now, as a number of recently established gold mining operations involve Canadian partners. Opportunities for joint ventures with U.S. firms, as well as the quality, quantity, and location of Montana's precious metals, have drawn the most Canadian capital to the state. The real estate market is another area of concentrated investment activity by Canadians, particularly recreational properties in the Flathead Lake area and commercial properties in Billings. Although the agreement is unlikely to affect Canadian investors directly, the declining value of the U.S. dollar should accentuate the attractiveness of Montana's property and mineral resources.

Politics of the Agreement

The easiest, but overly simplistic, way to assess the potential economic impacts of bilateral free trade is to assemble lists of "winners" and "losers." According to most projections, the clear winners in the United States are large financial services firms, transnational corporations (mainly in the automotive, energy and manufacturing sectors), and consumers. The losers are presumed to be some natural resource producers mainly in the West, and uncompetitive industrial plants scattered across the country. Some view the agreement as regionally biased in favor of the large, service- and technology-based firms concentrated in the East.

Several Montana industries have voiced their strident disapproval of the FTA. They support a coalition of senators, mainly from the West, who have sought to scuttle the deal unless the negotiations are revised to deal with issues about nonferrous metals, coal, plywood, uranium, wheat and natural gas. The general criticism is that the FTA will have a materially damaging effect because it eliminates tariffs on imports from Canada but allows Canada to keep export subsidies in place. Thus, as would-be "free traders," they assert that the FTA is flawed because it does not go far enough to guarantee "fair trade" as measured by the so-called "level playing field" (Baucus 1988).

Grain products

Canada shipped nearly 400,000 tons of wheat to the United States in 1986, nearly all of it destined for flour mills in or near Buffalo, New York. Grain growers are concerned that the FTA would further open the U.S. border to imports of Canadian wheat by abolishing the $.21 per bushel tariff. Meanwhile, Canada's import licensing system that effectively bans any shipment of U.S. wheat into Canada would stay in place.

While Canada's exports do not compete directly with Montana grain (over 80 percent of which is shipped

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to Asian markets) the fear is that these increases in Canadian exports would shift North Dakota wheat from the eastern to the Pacific market and therefore put indirect pressure on Montana producers. There is also a concern that Canadian grain growers might somehow take advantage of the U.S. Export Enhancement Program incentives to include their wheat in shipments to other countries.

The grain growers' main argument is that the FTA does nothing about Canadian "Crow rate" rail freight subsidies that give their Alberta and Saskatchewan competitors an edge in shipping eastward. In 1984, a phase-out program was initiated that shifted the financial benefits from growers to the railroads to ensure their viability and mandated a number of long-overdue technical improvements. Still, American farmers complain that even under the new formula, Canadian competitors enjoy an advantage that amounts to as much as one-quarter of the world price of wheat (National Association of Wheat Growers 1987).

These arguments mix fact with supposition. The fear about disrupting the wheat market may not be well-founded. New York purchasers of Canadian wheat have claimed that their decisions are based on quality as well as price. Moreover, there may be alternative markets for North Dakota wheat, because the Export Enhancement Program supports shipments to a growing number of less-developed countries in Africa, Asia and Latin America. In short, the anticipated increase in Canadian wheat exports may not materialize, and even if it does, the impact on Montana wheat growers could be negligible. Furthermore, the agreement would allow the United States to reimpose tariffs in the event that import surges severely disrupted domestic markets.

The appearance of unfairness in rail subsidies and in Canada's maintenance of restrictive import licensing for wheat also hinges on the measurement and definition of subsidies. Canada is obligated to remove the trade barrier if and when support for U.S. wheat growers is the same as in Canada. A complex formula was used to calculate the value of various government support programs in both countries, including Canada's railway subsidies for grain. The results show that U.S. wheat producers currently enjoy substantial advantages. Recent USDA figures support this conclusion; they indicate American subsidies are over twice as large as Canadian ones (Stokes 1987).

Wheat producers who are unhappy with some terms of the agreement tend to ignore others. The FTA would establish a binational team to work toward closer harmony in support levels and thereby allow for future reciprocity in global wheat trade. This provision is arguably far more important to Montana's grain industry than those concerning cross-border wheat trade. Enormously costly subsidy wars between the world's grain exporting giants are already straining federal treasuries and undermining the future of Montana agriculture. Joint action by the United States and Canada to bring about the worldwide abandonment of agricultural export subsidies is in the Montana farmer's best interest (Allen 1987).

The Asarco smelter at East Helena

Officials at the East Helena smelter are concerned that the FTA's elimination of tariffs on Canadian imports would threaten the operation's economic viability. Mines in Idaho that are located nearer a Canadian smelter at Trail, British Columbia, would no longer have a price incentive to ship their ores to Montana. The Lucky Friday mine, for example, has contracted to divert a portion of its output to Trail in 1988.

There is no doubt that the shutdown of the plant would be a blow to Lewis and Clark County and the city of East Helena. The company has reminded state officials in recent months that the smelter employs approximately 350 workers and pays nearly $1 million in local property taxes. The question is whether such a closure would result sooner from market conditions than from Canadian competition. Under the FTA, Asarco would have ten years in which to adjust to the phased removal of the tariff that is only a modest 3 percent.

Asarco's main concern is with subsidization. The Canadian government provides direct and indirect support to the minerals extraction industries through the operation of publicly-owned "Crown" corporations and through various grant, loan, and loan guarantee programs for private firms. The Non-Ferrous Metals Producers Committee, including Asarco, has argued that federal and provincial subsidies constitute "perhaps the most serious inequity in U.S.-Canadian trade relations." The committee opposes the FTA on the grounds that "it will ultimately lead to a significant competitive advantage for the Canadian producers" (Muth 1988).

While it is true that total subsidy payments to the Canadian smelter amount to $135 million, over half take the form of equity investments made by the Federal Business Development Bank. The rest come mainly from provincial and pollution control programs, but in no instance are the subsidies direct grants, as has been alleged. At the same time, Asarco's annual report for 1986 shows that the company owes $37 million to Lewis and Clark County for pollution control bonds, generally considered a subsidy because of the deferred payments and below-market interest rates involved. United States trade officials are justifiably circumspect about crying foul until U.S. subsidies, many of which are hidden by complex formulas and technical jargon, are identified for the purpose of side-by-side comparison.

The FTA calls for a five- to seven-year period during which a binational team of experts will try to find some means of reconciling disparate methods of providing public support to a wide variety of private industries in the two countries. This allows for the subsidy question to be resolved prior to the complete removal of tariffs in ten years. In the meantime, the FTA does not preclude Asarco

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from using U.S. trade laws to combat allegedly unfair subsidies given to Canadian smelters, such as assistance to reduce acid rain. Also, East Helena may prove a potential case for deserved federal adjustment assistance if the U.S.-Canada agreement does in fact lead to production curtailments, lay-offs, or even closure. There are also other important questions about the long-term viability of lead smelting in Montana — including supply and demand factors, worker health regulations, and corporate strategy — that require additional research and analysis.

Plywood

The FTA would remove the 20 percent U.S. duty and the 15 percent Canadian duty on imported plywood. United States plywood manufacturers want the agreement to go one step further, to require a change in the Canadian standards that restrict the importation of U.S.-made plywood. The American Plywood Association argues that restrictive building codes effectively prevent 80 percent of U.S. plywood from being sold in Canada. The removal of tariffs, therefore, will only help Canadian producers to increase their share of U.S. markets.

The British Columbia Council of Forest Industries argues that Canadian plywood, using indigenous species and different veneers, is of much higher quality than American, and that the construction standards reflect this qualitative difference. United States producers claim that American CDX plywood is as good as any in Canada and that its use in Alaska belies Canada's assertion that the American product does not stand up to cold weather. Because most other countries accept U.S. plywood standards as reliable trademarks, the Canadian barrier is patently discriminatory (American Plywood Association 1988).

Federal negotiators tried to fashion a compromise on this issue by requiring the Canada Mortgage and Housing Corporation (similar to the U.S. FHA) to evaluate American plywood. In March, the CMHC rejected the U.S. product on the basis that lower production standards created an unacceptable risk of delamination (a problem separate from that of cold weather durability). The U.S. industry now has the option of asking the Canadian decision to be reviewed by an investigative panel. If such a review is requested, the panel would have to complete its review by January 1, 1989. The American Plywood Association will probably urge U.S. officials to delay tariff revisions until a satisfactory solution is reached (Bureau of National Affairs 1988).

Whether the FTA would result in any injury to Montana plywood production is unknown. Champion International, after all, operates wood products manufacturing plants in both countries. In 1986, nearly $7 million worth of plywood, paperboard and related manufactured wood products were shipped to Canada from Montana (Statistics Canada). It makes sense that this volume would increase with the removal of the tariffs, even if the building codes remain in place.

Energy resources: coal, uranium, and natural gas

Coal producers are concerned that the FTA affords them no protection against competition from new Canadian power projects. One allegation is that Canada does not require equivalent pollution control on thermal plants; the second is that the provinces provide a variety of subsidies to hydropower projects that encourage dumping in U.S. markets. In reality, Canada produces very little electricity from coal and exports none of it. Further, Canada's treatment of hydropower is very similar to the way in which the U.S. government developed the TVA and the Columbia River: Canada simply enjoys the advantage of more numerous sites suitable for development.

Rather than seeking the so-called "level playing field" in electricity, some producers in the United States sought to use the FTA negotiations to retain markets likely to be lost to comparative advantage in Canada. The U.S. succeeded in maintaining the status quo in the Pacific Northwest where the Bonneville Power Administration can control access to the California tieline as a way to restrict imports from B.C. Hydro. Coal companies did not achieve, however, their goal of putting controls on the midwestern electricity market that is already a model of unrestricted trade.

Uranium and natural gas are similar cases. American producers face competition from Canada's more favorable production conditions. Larger and higher-quality deposits of some minerals, for example, are classic cases of comparative advantage. New Mexico uranium interests know that they cannot compete with the richer grades of Saskatchewan ore without some form of trade protection couched in the language of national security (Haglund 1987). Alberta natural gas also has a comparative advantage, and some American producers are concerned that they will be at a disadvantage unless key regulations are maintained with the passage of the FTA (Coffield).

Montanans who remember the last energy crisis (when the state received half its gas from Canada) will recall that the main concerns in the 1970s were availability and reasonable prices. It would seem ridiculous today to seek to prevent Canada from assuring U.S. consumers that they can count on supply and fair prices in the case of another energy crisis. All aspects considered, the single most important advantage of the FTA to the United States may turn out to be the guaranteed access to Canada's energy resources (Netherton 1988).

A political overview

Some of the FTA's detractors seem to ignore the reality that subsidies are a two-way street. In one sector after another, the trade officials faced difficult trade-offs because both national economies are so laced with direct and indirect subsidies. With deadlines looming, the negotiators finally backed away from putting all subsidies on the table.

If the opponents are successful in killing the FTA, in many cases they will not have succeeded in addressing

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the real grievances they raise. The complications with regulation of natural gas will remain. The alleged subsidies of hydropower will be unchanged. Canada will continue to supply smelters with incentives that help reduce acid rain. On the other hand, passing the FTA does bind both sides to a renewed examination of which subsidies should be considered fair and foul in the debate over trade distortion. The two countries can hardly be expected to take the more difficult second step until they have taken the first one—the adoption of the FTA as a framework for ongoing talks.

A coalition of senators wants the agreement renegotiated to address the specific concerns of the industries that are vulnerable to changes in the world market. This demand is unrealistic since the senators know fully well that it violates the procedure Congress agreed to under the "fast-track" legislation. Once signed, the agreement is a package. If one side promotes "clawbacks" into the agreement (Rose 1987), the other will be forced to counterattack and the entire package could come undone. That is one reason why U.S. trade law separates executive branch negotiations from the inherent pressures for log-rolling in Congress. If the "level-playing field" objectors are really serious about achieving free trade, they should welcome the provision in the agreement calling for further negotiations to mutually eliminate the subsidies that are out of bounds.

The Challenge of Economic Diversification

Economist Peter Drucker argues that the resource sector has been separated from the industrial sector in the world economy; the demand for raw materials is on a downward curve. The most pressing problems with many agricultural and mineral industries result from global competition, and retaining a share of shrinking markets is a daunting prospect. Attacking the U.S.-Canada FTA is largely an assault on symptoms, not causes of economic distress. Protecting jobs from import competition in these sectors is likely only to shift the burden to others. Drucker advises that "a country, an industry or a company that puts the preservation of ... jobs ahead of international competitiveness will soon have neither production nor jobs" (Drucker 1986). In this paradigm, if the Montana economy fails to make the transition then it is destined to decline.

There are many opportunities under the FTA for expanding value-added sectors. These are some of the possible areas in which entrepreneurial firms in Montana might find a niche for their products and services if Canadian tariffs are removed:

- medical technology
- specialized food products
- athletic apparel and outdoor recreation equipment
- chemical and pharmaceutical products
- water quality, treatment, storage methods and machinery
- pollution abatement techniques
- oil and gas exploration equipment
- plant genetics and biotechnology
- computer applications to farming and ranching
- waste and byproducts recycling

The Montana economy should not rely only on commodities that originate within the boundaries of the state. The emphasis should be on adding value, whether it is adding value to Montana resource commodities or combining Montana talent with imported goods that are re-exported. Efforts are already underway in this direction, but more work is needed. The FTA is one way to invigorate these efforts.

Tourism is also a growth industry enhanced by the FTA. Tourism is a relatively recession-proof industry in Montana, and Canadian visitors play an important role in sustaining the park facilities, hotels, restaurants, and other travel-related businesses. In 1985, for example, more than 400,000 Canadians came to Montana and spent over $32 million (Montana Promotion Division 1987). There appears to be a sort of minimum threshold for Canada's contribution to Montana's tourist economy. Federal Reserve Bank figures for the last five years show, for example, that even when the U.S. dollar is highly overvalued there is a reliable stream of visitors from north of the border. Two major factors help explain this pattern. First, Montana is the only direct "land bridge" for residents of Alberta traveling to the United States. The Albertan penchant for sunnier, warmer climes in the winter months, as well as many family ties across the border, are a constant stimulus. Second, higher relative prices in Canada for gasoline, lodging, restaurant food and entertainment help to offset the unfavorable exchange rate.

The FTA does not address currency values. Freer trade, however, is likely to bring the U.S. and Canadian dollars into closer harmony over the long run. The Canadian dollar has appreciated significantly in recent months, and although this trend cannot be directly attributed to the prospective trade agreement, it nevertheless bodes well for Montana's Canadian tourist connections. Even without free trade, Canada is key to the state's travel industry expansion. The joint tourism promotion efforts of Montana and Alberta officials, emphasizing the "two-nation vacation" theme in foreign markets, is evidence of a growing sense of interdependence.

Conclusion

As with any deal between willing partners, both sides are better off under the free trade agreement than without it. Within each country, the benefits and risks are not shared uniformly across all sectors. But care has been taken to ensure that no one region or industry is forced to carry the burden of the agreement. The changes rendered by the FTA are implemented in stages. Many safeguards are included to restore equilibrium if certain trade-sensitive sectors suffer unanticipated harm.

The ten-year tariff reduction schedule gives affected industries time to adjust to new competition. Some provisions can be abrogated through the unilateral action of either country if there is an unwarranted surge of exports. Finally, either nation can terminate the agreement with only six months' notice and it is automatically repealed if the two nations fail to find a definitive method of dispute resolution in the seventh year.

This cautious approach means that the free trade agreement is neither the salvation nor the bane of either economy, but it does promise to stimulate growth in each. Americans and Canadians alike will be able to purchase less expensive goods in the neighboring country while overseas imports are still subject to tariffs. Canadian producers gain more assured access to a larger market; American producers gain because Canadian tariffs are about twice as high as those in the United States.

For Montana, free trade is no panacea for economic difficulties and the benefits cannot be distributed equally in all sectors of the state economy. There will be adjustment costs to some traditional producers. On the other hand, many Montanans will gain from the agreement. In addition to the consumers who receive lower prices and a greater variety of goods and services to choose from, the beneficiaries include aspiring entrepreneurs in the value-added industries that are the primary target of economic diversification programs in the state. They also include many traditional producers who conveniently forget that they have an interest in lower input costs, like wheat farmers who benefit from unregulated border oil prices and inexpensive fertilizer from Saskatchewan. They include all Montanans of the future, who will gain through the FTA a right to share Alberta's energy resources in the event of an oil crisis.

On balance, the risks to the Montana economy do not appear to outweigh the gains of going forward with the free trade agreement with Canada. The FTA provides an important way to invigorate the value-added sectors in Montana. If Peter Drucker is correct, and the demand for raw materials is on a downward curve, the Montana economy must choose to diversify if it is to survive. □

This article is a summary of an extensive analysis of the U.S.-Canada free trade agreement. The full report is available in June from the 49th Parallel Institute, Montana State University. The authors would like to acknowledge the Northwest Area Foundation of St. Paul, Minnesota that provided the assistance for research over a two-year period.

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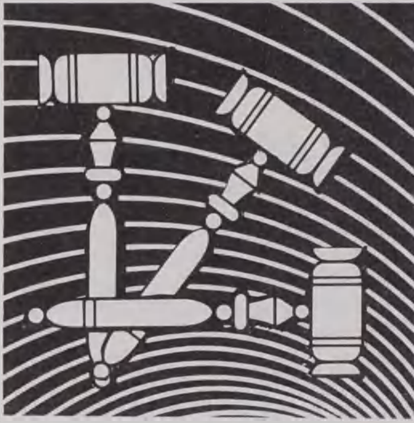

Bad Faith: Liability Law in Montana

JERRY FURNISS
JACK MORTON

Why do we have a bad faith liability problem in Montana? Many are eager to place blame with attorneys, while others quickly accuse jurors of being too eager to dip into the pockets of employers, bankers, or insurance companies. Still others focus attention upon the state legislature and feel that it has attempted to over-regulate our lives. Almost unnoticed in the hullabaloo, however, has been the role played by the courts, particularly the Montana Supreme Court. The Montana Supreme Court has, without reservation, adopted the concept of bad faith, a novel legal theory that lies at the heart of the liability debate that exists in Montana today.

The Montana courts have been at the nation's forefront in the development and application of the concept of bad faith. Few states, if any, have gone as far as Montana.

As an example, let's take a look at the area of employment law. Let's assume that an employer has workers in both Idaho and Montana. Our employer has just decided to terminate an employee in Montana, and also terminate one of his Idaho employees. The reason the employer gives for the terminations is that the work simply has not met the employer's expectations. Neither of the workers had fixed-term employment contracts. Both employees were hired under what is known as an employment-at-will arrangement. Employment-at-will simply means there is no fixed employment term; the employer or employee can terminate the relationship at any time, that is, at will.

Let us also assume that both employees are upset with the termination, and decide to pursue legal action. The result of the Idaho litigation will almost certainly be in the employer's favor. To quote a 1986 Idaho Supreme Court case,

> The rule in Idaho, as in most states, is that unless an employee is hired pursuant to a contract which specifies the duration of the employment, or limits the reasons for which the employee may be discharged, the employment is at the will of either party, and the employer may terminate the relationship at any time for any reason without incurring liability.

The outcome would likely be the same in nearly every other state, except Montana.

The result of the Montana litigation may well be totally different. Our employee will almost certainly allege that the employer was guilty of bad faith and may receive not only compensatory damages for lost wages but also punitive damages of perhaps a million dollars or more.

The Montana court has decided that all contracts including employment contracts contain an implied obligation of good faith. That would not create a serious problem if it were not for the fact that the court has declared that a lack of good faith can be established by mere "unreasonable" conduct or by conduct which fails to meet "the justifiable expectations of the other party." Thus, a jury may get to review any contracts to determine whether the actions were unreasonable or contrary to the other party's expectations. Cases where the jury finds a lack of good faith, are generally known as bad faith cases.

The truly radical legal change came when the court decided that bad faith is not just a contract matter, but is also a tort. With that decision, the court put bad faith cases in the same basket as the tort theories of fraud, libel, assault, and battery. As a result, juries can award not only compensatory damages for breach of contract but may also assess punitive damages designed to punish the aggrieving party if the tort of bad faith is involved.

Because of the court's extremely liberal definition of good faith, the charge of bad faith and the resultant claim for punitive damages have now become a standard factor in nearly all contract disputes.

In most states today (and in Montana, up until several years ago) breach of contract and tort lawsuits are distinctly separate. In a contract matter, it is assumed by the courts that a party has the right to breach a contract if the breaching party is willing to compensate the other party for actual damages. Those damages are known as compensatory damages and are designed to make the aggrieved party whole. Normally the jury is not allowed to punish the breaching party by awarding punitive damages. The jury's role is restricted to awarding compensatory damages in a breach of contract action to compensate the aggrieved party for actual damages incurred.

The issue of punitive damages simply does not arise, in most states, unless the matter involves an intentional tort such as libel, slander, assault, battery or fraud. Unlike compensatory damages, punitive damages are designed to actually punish a party for having intentionally committed a grievous act. Punitive damages are designed to make an example of the other party, and are often known as exemplary damages. While a jury's award of compensatory damages can be measured against an actual loss incurred, juries have nearly unbridled freedom to determine the amount of punitive damages, and as a result, multi-million dollar punitive damage awards are not uncommon. In Montana, this clear distinction between contract and tort theory has been eroded because of Montana court decisions. As a result, what used to be simple breach of contract matters have now mushroomed into complex actions involving the ominous theories of bad faith and punitive damages.

The development of bad faith as a

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tort concept in Montana had its origin in insurance cases. For the past twenty years, Montana courts have expressed concern about insurance companies dragging their feet when settling claims. Through a series of cases, the Montana courts attempted to encourage insurance companies to settle fairly and promptly by holding that every contract contains an implied promise or covenant of good faith.

Although the Montana courts have not clearly defined bad faith, the courts have indicated that bad faith may be found in situations where a contracting party's behavior is malicious or oppressive. In recent cases, however, the Montana Supreme Court has extended the application of bad faith to cases involving merely unreasonable behavior by a contracting party. In a 1986 case, the Montana Supreme Court stated, "In a commercial setting we now have held that where the conduct of one party unreasonably breaches the justifiable expectations of the other party, an action in tort results."

The Montana Supreme Court failed to provide a definitive standard or test for determining what is bad faith. This has not, however, prevented the court from applying the concept of bad faith to a wide variety of commercial transactions.

Bad faith in Montana banking cases

The banking industry, in particular, has had its practices subjected to close scrutiny by the Montana Supreme Court through the application of the bad faith concept. One of the earliest banking bad faith cases was the 1984 *First National Bank in Libby v. Twombly* case. In that case a First National Bank officer made a $3,500 loan to the Twomblys for the purchase of an ice machine. The Twomblys expected to use the ice machine in a restaurant they hoped to open. When the negotiations for the purchase of a restaurant failed, the Twomblys experienced financial difficulties. They approached an officer of the bank who agreed to extend the payment date on the loan. Another officer of the bank, who was not aware of the bank's agreement to extend the loan, called the loan due and offset the Twomblys' checking account, leaving them with a balance of only $1.65. The bank then sued the Twomblys to recover the balance owing on the loan. The Twomblys counter-claimed against the bank for bad faith. The Montana Supreme Court held that the bank was liable for bad faith and held the bank responsible for punitive damages.

In 1985, the Montana Supreme Court upheld another bad faith case against a bank. The *Tribby v. Northwestern Bank of Great Falls* case involved a jury award of $120,000 compensatory damages and $1 million punitive damages. Tribby and a relative were involved in a commercial real estate venture. They had their joint checking account at Norwest Bank. The checking account contract required signatures of both parties on all checks. Tribby found, however, that checks were being honored by the bank without his signature. After failing to resolve this problem with the bank, Tribby filed suit against Norwest. Norwest responded by placing Tribby's outstanding loan on a "watch list" and refused to renew a loan that had been renewed annually for several years. Norwest Bank also cancelled Tribby's Ready-Reserve Account that had allowed Tribby to write checks exceeding the balance in his checking account. Although the matter was eventually remanded for retrial at the district court level due to improper jury selection, the Montana Supreme Court held that this set of facts did merit the application of the bad faith concept. The court stated, "We hold only that the district court, under these circumstances, did not err when it instructed the jury to consider recovery under tort principles and, accordingly, punitive damages."

In a 1987 case, *Crystal Springs Trout Co. v. First State Bank of Froid,* the Montana Supreme Court upheld an $800,000 judgment against a bank officer, Jerry Wolinder, who was unable to carry through on a promised extension of credit to the trout farm. Wolinder had represented that his bank would have "no problem" obtaining sufficient financing for the trout farm operation. Wolinder was, however, unable to obtain the promised financing and the trout farm floundered. The court affirmed the damage award against Wolinder based on a lack of good faith.

There have been numerous other cases in Montana involving bank practices and the concept of bad faith. Bankers frequently find themselves subject to litigation involving customer complaints where the bank has failed to extend credit that was impliedly promised or merely expected, or where they have "unreasonably" called loans due. There have also been suits brought against banks alleging that banks have loaned too much money to borrowers, and that the banks should have known that the borrowers would not be in a sufficient financial position to repay the loans.

Bad faith in wrongful discharge cases

Another area that has evolved very rapidly in Montana is the wrongful discharge of employees. The Montana Supreme Court has implied a covenant of good faith and fair dealing in the employment context and has treated the breach of this as a tort with the resultant punitive damages.

Historically, employers could discharge employees without cause. This doctrine, referred to as the at-will doctrine, has remained relatively intact in all but a few states. The Montana Supreme Court has gone farther than any other court in abolishing the employment-at-will concept.

In 1983 in *Gates v. Life of Montana Insurance Co.,* the Montana Supreme Court first established the requirement that employers deal in good faith with their employees. Gates was working under an oral contract with no stated term and was thereafter terminated without

"The impact of the bad faith concept on a wide variety of different transactions cannot be overestimated."

warning. The court concluded that the company's dismissal of Gates might violate an implied covenant of good faith and fair dealing. The case was remanded to a lower court for determination of whether the dismissal was in bad faith.

In a 1984 case, *Adair v. Montana Petroleum Marketing Co.*, the Montana Supreme Court gave some clarity to the issue of when the implied covenant of good faith and fair dealing would arise in the employment setting. The court held that the covenant of good faith existed whenever there were "objective manifestations by the employer giving rise to the employee's reasonable belief that he or she has job security and will be treated fairly." Although the *Adair* case did not clearly define what constituted a lack of good faith, it should put employers on notice that destroying an employee's expectations of continued employment may constitute bad faith and subject the employer to punitive damages.

In 1986, the Montana Supreme Court upheld an award of $1.3 million in punitive damages in the case of *Flanigan v. Prudential Federal Savings and Loan Association.* Mrs. Flanigan had been an employee for approximately thirty years and was terminated from her position as loan counselor based on an alleged reduction in work force. The bank president's testimony that referred to Mrs. Flanigan as "ballast" did not help Prudential's position. The Montana Supreme Court held that the jury could have inferred malice from Prudential's actions and that malice could support an award of punitive damages. The Flanigan case should again be a reminder to employers that they may be held liable for punitive damages by disgruntled employees who feel that their employers' actions are unreasonable and thus constitute bad faith.

Perhaps the most controversial Montana bad faith case was a 1986 case from Butte, *Dunfee v. Baskin-Robbins, Inc.* In this case Terrence and Patricia Dunfee purchased a Baskin and Robbins franchise operation. The purchase price of $71,000 was funded with an Small Business Administration (SBA) guaranteed loan. The franchise operation was already located in the Raymond Mini-Mall. The operation was quite successful for a ten-month period, at which time the configuration of the mall's parking lot was rearranged. The change in the parking lot resulted in decreased traffic, and the Dunfees desired to move the operation to a larger mall, the Butte Plaza. They contacted the district manager of Baskin and Robbins, Sharon McCarthy. She informed the Dunfees that the franchise could not be moved to another mall because of stipulations in the existing lease. McCarthy did not, however, contact the appropriate Baskin-Robbins vice president to ascertain whether the vice president would approve such a move. McCarthy also failed to tell the Dunfees that the existing lease had both a subleasing provision and a right to terminate after five years.

The Dunfees were under the mistaken impression that the lease could not be terminated for a fifteen-year period. The operation eventually failed and the SBA foreclosed on the assets.

The Dunfees then brought the action against Baskin and Robbins, alleging bad faith. The jury agreed with the Dunfees allegation and awarded the Dunfees $300,000 in punitive damages in addition to $230,000 in compensatory damages. Mrs. Dunfee testified that she had become distraught when the operation failed and that she had lost her self-esteem. Mrs. Dunfee testified also that she tried to avoid going back into Butte where she felt ashamed for being recognized as a failure. The jury recognized this as emotional distress, and awarded Mrs. Dunfee an additional $150,000 to compensate her for mental and emotional distress. The Montana Supreme Court affirmed the district court judgment, although it is important to note that the decision was a four-to-three decision, and that one of the members of the majority, Justice Morrison, is no longer a member of the court.

Other applications

The impact of the bad faith concept on a wide variety of different transactions cannot be overestimated. The insurance industry, for example, has been struck by both edges of the sword. Insurance companies find that they are faced with raising premiums due to the increased risk that businesses face from bad faith claims; at the same time, insurance companies are having to pay claims at an accelerated rate because of their potential bad faith liability for not promptly settling claims.

Surprisingly, pricing decisions by businesses may also be subjected to the bad faith concept. Recent court cases in Oregon and California ruled that banks' charges for insufficient funds checks must be set in good faith. Those courts held that banks' service charges for insufficient funds checks amounted to contracts of adhesion because there was little bargaining power between the customer and the banks. In those situations the courts held that the banks, being in a superior bargaining position, owed an obligation of good faith to the customers when setting those service charges. As a result, the banks have been subjected to class action suits for up to $30 million. The banks lost both of those court cases and review was denied by the U.S. Supreme Court.

If the Montana courts follow the same line of reasoning and apply the bad faith concept to the pricing decisions of Montana businesses, the result could be momentous for a variety of businesses. Not only banks, but hospitals, title companies, insurance companies, gasoline distributors, and a variety of professionals such as doctors, lawyers, stockbrokers, accountants and real estate brokers could be faced with price-setting bad faith claims. According to the court decisions in California and Oregon, there appears to be no way around the charge of bad faith unless the businesses can show that the individual charges reasonably reflect the actual cost of the service and that individual customers are presented with a

"The results of these tort cases could dramatically change the way many businesses handle their relationships with their individual customers."

meaningful opportunity to negotiate. The results of these tort cases could dramatically change the way many businesses handle their relationships with their individual customers.

Constitutional background

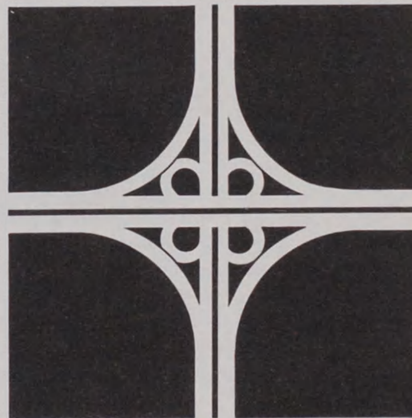
Perhaps the primary reason for the lack of legislative response to the bad faith issue has been a provision in the Montana Constitution, which specifies that each injured individual is entitled to full redress for any injury. Prior to the last legislative session, a variety of factions successfully proposed Constitutional Initiative 30 (CI-30), which specified that the legislature has the authority to limit the amount of recovery by injured individuals. CI-30 was passed by the voters, and the Montana legislature did enact a number of "tort reform" measures in the last session.

For instance, in the area of employee discharge, the legislature almost completely abolished the recovery of punitive damages by an aggrieved employee. According to the new legislation, an employee who wins in court will likely recover only compensatory damages. In effect, this legislation attempted to take the bite out of employee discharge bad faith cases.

The legislature also addressed the issue of the liability of corporate boards of directors. Increasingly, board members have found themselves subjected to suits brought against them by shareholders alleging that board members were negligent or careless in performing their duties. Of course, these lawsuits are most common in situations where the corporation is not as profitable as expected. The legislature attempted to deal with this problem by providing that corporations may, by shareholder vote, amend their articles of incorporation to provide that board members will be liable only for intentional actions that harm the corporation, but will not be liable to shareholders for mere negligence. This change may make it easier for corporations to obtain liability insurance for their board members, as well as to attract new board members. It should be noted, however, that this change applies only to those corporations whose shareholders vote to so amend their articles of incorporation.

Much of the hope for resolving the bad faith issue rested upon bills introduced in the last session to change the Montana Supreme Court's definition of bad faith. Those bills were very controversial, and the result appears to be that the legislature has simply codified the Supreme Court's liberal bad faith definition. Rather than greatly limiting the situations where bad faith can apply, the Montana legislature specified by statute that bad faith actions can arise from any situation involving either a lack of honesty in fact or a failure to observe reasonable commercial standards. No doubt, the murky issue of reasonable commercial standards will arise many times in future litigation.

Not long after the legislative session finished, the Montana Supreme Court handed down a decision invalidating CI-30 for various technical reasons. The court was primarily concerned with the process by which the initiative had been presented to the voters. Now that CI-30 has been invalidated, even the limited tort reform passed by the last session of the legislature is certainly suspect. Although there have not yet been any Montana Supreme Court cases invalidating any of the tort reforms adopted by the last legislature, there have already been a number of challenges made in district courts to those reforms. It would not be unreasonable to expect that the tort reforms passed by the legislature will meet the same fate as CI-30 when they get before the Montana Supreme Court.



The outlook

Because of what happened to CI-30, we are again faced with a great deal of uncertainty. Another version of CI-30 may be proposed to the voters. Some argue that all of the tort reforms passed by the last session of the legislature will need to be readopted by a future legislature if the constitution is successfully amended.

Another factor to consider is the makeup of the Montana Supreme Court. Now that Frank Morrison, author of some of the most far-reaching bad faith decisions, has resigned from the court to run for governor, court observers are waiting to see if the next series of bad faith cases take a different direction.

Montana businesses now face greater uncertainty than ever. Because of doubt about the future direction of the Montana Supreme Court, doubt about the extent or availability of insurance coverage, and doubt about the applicability of the tort reforms passed by the last Montana legislature, businesses need to be ever more aware of their potential liability in the area of bad faith. □

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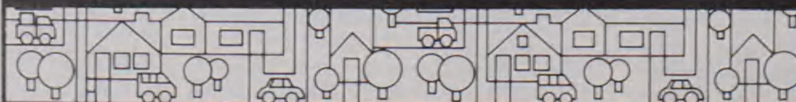

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The *Montana Business Quarterly* is currently supported by a generous grant from the Burlington Northern Foundation, which represents the following Burlington Northern, Inc. subsidiaries: Burlington Northern Railroad Company, Glacier Park Company, Meridian Minerals Company, Meridian Oil, Inc., and Plum Creek Timber Company, Inc.

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