

Canadian Climate Policy: A Customizable Approach

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By

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Dr. Christopher Ragan, Chair of Canada's Ecofiscal Commission, came to campus this past March as part of the Lazaridis School of Business and Economics Economist-in-Residence Speakers Series. Dr. Ragan spoke to faculty and students about how "ecofiscal" policies work and why institutions like the Ecofiscal Commission may become increasingly valuable in a polarized political landscape. Canada's Ecofiscal Commission was launched in November 2014 with a 5-year mandate to identify policy options to improve environmental and economic performance in Canada.

Dr. Ragan is an Associate Professor of Economics at McGill University and a Research Fellow at the C.D. Howe Institute. His research relates mostly to the conduct of macroeconomic policy, inflation targeting, exchange rates, and monetary policy but he has also written on fiscal policy, financial stability, and slow growth.

Derek Ensing, a graduate student in Laurier's Master of Arts in Business Economics program had an opportunity to ask Dr. Ragan about Canada's decentralized approach to carbon pricing and possible takeaways from recent carbon pricing challenges in the European Union and the US.

DEREK ENSING: Canada does not yet have a single, economy-wide, carbon pricing system in place. Instead, provinces have been introducing their own initiatives in piecemeal fashion since 2007. Ontario and Manitoba appear set to join Quebec in introducing their own provincial cap and trade systems, linked in some way to each other (and possibly to California).¹ The Atlantic provinces have also been discussing the possibility of a regional carbon tax.

What are the advantages and disadvantages of Canada's decentralized approach?

CHRIS RAGAN: It seems to me the advantages are two things: customizable policy and revenues for the provinces. The first advantage is that the provinces are different. Their energy mixes are different and their economic structures are different so I think each individual province would have an incentive and a desire to design the system in a way that makes sense given its unique circumstances and objectives. While that could happen from a federal policy it is just less likely because federal policy tends to be designed as one-size-fits-all. The second advantage is the revenue. If you are going to have a provincial system that is pricing carbon within a province then the province is going to be keeping the revenue. With a federal system, the provinces might get the revenue or they might not.

The one big thing that speaks to the disadvantage of a provincial approach is that you get provinces that don't do anything at all (special case to the general point that you might get different carbon prices across provinces). There are obvious economic questions. But there are also obvious economic benefits that come from price alignment but don't necessarily come from policy alignment. That wouldn't be an issue if you had a single pan-Canadian price but it becomes an issue potentially if you have a bunch of provincial systems.

¹ <https://news.ontario.ca/opo/en/2015/12/ontario-quebec-and-manitoba-form-a-dynamic-alliance-to-fight-climate-change.html>

DEREK ENSING: Is there a role for the federal government in organizing or coordinating such a system, and what kinds of tools does a federal government have to compel provinces to comply?

CHRIS RAGAN: So then the challenge is to say OK, can we get the benefits of the provincial approach and not suffer the downside. The way you do that is coordinate these provincial systems so they converge on a price. Then the question is how do you do that? A possibility is that you could get provinces to come together to do that on their own or perhaps the federal government can play a facilitating role. Do the feds actually play a role in pricing or are they just playing a role in coordinating and facilitating the provinces' policies? And then you come back to this issue if you have a province that just doesn't want to do anything.

Can the feds spur the provinces along? At the simplest you could imagine a federal government that says were going to impose a carbon pricing policy, period. The federal government would essentially be saying "we don't care if you have got carbon capture and storage, we don't care if you've got your own policy, you can roll back your policy if you want. We are just going to do it". It is like when the federal government introduced the GST. First, they introduced a GST and it didn't matter if a province had or didn't have a PST. Then came the second stage where the federal government decided to harmonize the GSTs with the PSTs and that worked in some but not all cases. I think if the federal government wanted to it could introduce a carbon tax and have the revenue be retained federally. Beyond that there are other tools that Ottawa can use to entice the provinces comply. Could they offer a technology fund? Could they just offer money? If they gave 5 cents for every dollar the provinces collected in their own carbon pricing system, would that be enough? I think the answer is that it will be different, in different provinces, in different times, depending on the political dynamics, and the personalities, of the day. When you start thinking of how the federal government could sweeten the pot, there will be scope in this country quite apart from climate policy. For example, I think there will be a transfer of fiscal capacity from Ottawa to the provinces over the next 20 years. In anticipation of that, could the federal government buy a nice pan-Canadian carbon price? The answer might be yes.

DEREK ENSING: You mention the GST, in some sense there was some federal-provincial disagreement or failure to reach a consensus so the federal government went ahead and made some one-off deals with each of the provinces that eventually decided to harmonize. That's one approach. The other approach is to use the First Ministers' meetings, as was done in the past to negotiate income tax agreements. If you think about the sort of Prime Minister Trudeau is, I think he is more of the "everyone go back and sit at the table" kind of Prime Minister. What do you think? That might take a longer time for something to come out.

CHRIS RAGAN: It might be better, because those better things that might not be obvious from the beginning take lots of negotiation to get through, so the outcome may end up being better. The economics says we should really have a single price, not necessarily a single policy but a single price. From an administrative perspective you would probably want to have a single policy. Just imagine if you set the objective that there is going to be a single policy. For it to work, it probably has to be a federal policy. That means you roll up all the provincial policies.

What it requires is somebody who knocks the heads together and says "hey guys I know you want to defend your provincial interests but let's think about the bigger picture here and we are all part of the bigger picture and let's think about what's good for the country". You need

someone to say maybe we can start over on some of these issues, let's sweep these away and start over. I think you have got to be prepared to pose some of the questions that nobody really wants to pose. Because do you think Christy Clark is thinking about just folding up her policy? Probably not. Do you think Rachel Notley is thinking about folding up her program? Probably not. She is just in the middle of building it. All of the Premiers have got political constraints, and political objectives to satisfy but there is this big picture that it would be kind of nice to get everyone thinking about. I think that is the job of the Prime Minister. The question is whether in these federal-provincial discussions the federal government can be both the Federal government and an honest broker at the same time. I don't know if that is doable.

DEREK ENSING: Climate policy has unfolded rather differently in other federal-like systems. For example, the European Union launched its Emissions Trading System (ETS) in 2005.² It is the world's largest cap and trade system, covering everything from power stations to manufacturing plants in 31 countries. In your opinion has it been a success? What can we learn from the EU's experience that might help inform the decentralized approach to climate change policy that is unfolding here in Canada?

CHRIS RAGAN: My sense is that it has been successful, there has been complimentary policies that have also done some work. I would view the ETS as a system that got off to a rough start but that is working now. I think it is actually maligned for the wrong reason. A lot of people will say the price collapsed, the market collapsed, and therefore the ETS doesn't work. It is true that the price collapsed but it does not follow from a price collapse that the system is not working. It is, after all, a cap and trade system. So the measure of stringency that really matters is the cap. As long as their cap is set below where it would otherwise be, as long as the cap falls over time, and as long as you are actually measuring things properly and enforcing things properly, then your emissions are going down. Emissions have been going down, differently and in different EU countries, but emissions have been going down. People look at the price and they say well the price has collapsed and therefore cap and trade systems are no good. I hear that over and over again.

To me there are two reasons that the European system had a [price collapse](#). One was a mistake and my understanding is that they basically printed up too many permits in the opening years. So they had a system with too many permits and the price went way down. That's what happens when you do that. It was like a system where you printed too much money and you got some inflation. I also think that they corrected that problem. So they made a mistake, they had some uncoordinated excess printing of permits, the price fell, they fixed the problem subsequently and now we are back into a new regime. The second reason why the price either collapsed or stayed low was a macroeconomic reason. In 2016, the GDP in the Eurozone has returned to its [pre-crisis 2008 peak](#). That's 8 years. It's a statement about the seriousness of the crisis, and I would say an indictment about subsequent policy. So their GDP fell, and with a very slow recovery. It has basically been flat-lined for a few years. In that world of very low economic activity and low demand for anything, there is low demand for production and low demand for permits so that keeps permit prices low. That's not actually the system not working that's the system working perfectly. That's the way cap and trade systems are supposed to work. As long as the cap keeps falling over time and we are enforcing it emissions will keep going down. So the big

² http://ec.europa.eu/clima/policies/ets/index_en.htm

lesson from Europe is don't print too many permits and that macroeconomic factors have kept prices low.

DEREK ENSING: Building on your thoughts comparing monetary and carbon pricing policy, would a national carbon price create uneven regional effects in the same way a national monetary policy does?

CHRIS RAGAN: Why does a single national monetary policy generate uneven effects? Number one it is because different regions of the country and different sectors of the country respond differently to economic shocks. When the world price of oil goes down it is bad for Alberta and good for Ontario. We set monetary policy that is right on average which means it is wrong everywhere else. Would a national carbon price be wrong in the same sense? I don't see that it would be, because it is a micro policy where you are putting a price on carbon. It is going to have differential effects because a \$30/tonne carbon price has a different effect in Alberta than it does in Manitoba just because the structure of the economies is different.

DEREK ENSING: In Canada, the recent flurry of provincial carbon pricing announcements add to existing provincial carbon pricing policies already underway in BC, Quebec and Alberta. But in the United States, another pattern is emerging. Several states have backed away from cap and trade policies. In the Western Climate Initiative, 6 US states have withdrawn. The Midwestern Greenhouse Gas Reduction Accord or MGGRA (which initially consisted of 6 Midwestern states and 1 province) "imploded" by late 2011. And New Jersey withdrew from the [Regional Greenhouse Gas Initiative](#) in 2011. How does the lack of carbon pricing in the United States affect policy in Canada?

CHRIS RAGAN: I think the United States is interesting here because of President Obama's actions through the [EPA regulation 111d](#) that is putting requirements on states to reduce their emissions. The EPA regulation says you have to reduce your emissions by a certain amount but we are going to give you the flexibility to figure out how to do it. I think this has now created two dynamics. The first dynamic is a court challenge. The mentality is to blow the EPA out of the water, and then wait for the next president. The second dynamic is to figure how to reduce emissions and then you start getting conversations about maybe the solution is to price carbon. They see that British Columbia has a carbon price so maybe they can get together as a couple of states and price carbon like RGGI. While there is not a lot of carbon pricing going on in the states right now, that might be a bad prediction of what it might look like in a year or two or five. The global momentum is in the direction of carbon pricing. I have to believe, naively perhaps, that the US momentum is weakly up as opposed to strongly up.

The British Columbia carbon price is at \$30, it is higher than in Alberta, it is higher than in the northeast US, and they have a cement industry that has claimed to have been hurt. The Ecofiscal Commission has looked at this data and it is pretty hard to find any clear evidence the cement industry has been hurt. Nonetheless, the cement industry has lobbied the BC government for some special treatment and in the [2015 budget](#) the BC government carved out more than \$20 million over 3 years as transitional support for the cement industry. I think cement is not alone in being an industry that is making noise and you do get some business interests in BC talking about competitiveness issues. The competitiveness issue gets bigger and bigger as the gap

between BC's price and anybody else's price grows. If the competing jurisdiction is in Washington or Oregon and if your carbon pricing is way above them then there is a competitiveness issue. I actually think you can deal with the competitiveness issue as they have done with the cement industry, you could do what Alberta is going to do with its output-based allocations. I don't like this idea that because we have a competitiveness issue then we have a reason for not doing the policy or not progressing with the policy.

What we at Ecofiscal Commission (and others) need to do is to be talking to policy-makers across the country saying, of course, you have a competitiveness issue if you put in a carbon price. Of course you are going to have a household impact but we can address those problems head on with a small share of the revenue. If you wanted to completely offset the household impact from a \$30/tonne carbon price for your bottom 40% of your households you could do it for less than 10% of your carbon pricing revenues. You are left with 90% or let's say 85% of your revenues and you might take 20% of that to deal with your competitiveness challenges. Now you have 65% of your revenues left. There is a whole host of things you can do with the remaining revenue, including tax cuts as we have seen in BC.