Assessing Our Emerging Pan-Canadian Climate Policy

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October 2016

For almost three years, Canada's Ecofiscal Commission has been actively engaged in discussions about carbon pricing across the country. We have spoken with many governments, opposition parties, business groups and environmental organizations. Our emphasis has been on making the case for carbon pricing as the lowest-cost means of reducing GHG emissions, and also on the important details that must be incorporated into well-designed carbon-pricing systems.

On October 3 in the House of Commons, the prime minister announced his government's intention to ensure the existence of a carbon price in all parts of the country. The announcement led to much public commentary, on both the politics and the policy details. Here is our brief assessment of the federal announcement.

Let's begin by listing four key elements of an economically efficient climate policy.

1. A broad-based carbon price in all parts of the country. There is widespread agreement among economists that, within any given jurisdiction, a carbon price applying to a large share of GHG emissions can reduce those emissions at a lower economic cost than the alternative approach involving "command-and-control" regulations. Since governments usually lack detailed information about costs and technology within each sector, the regulatory approach typically fails to result in the lowest-cost outcome. In contrast, a transparent carbon price provides incentives for all market participants to seek out the lowest-cost reductions, as they pursue the enhancement of their own bottom lines.

2. A roughly equal carbon price across the country. For two reasons, the most efficient outcome for the country as a whole requires the carbon price to be equal across provinces and territories. First, having a consistent price prevents situations where low carbon prices in one part of the country create little incentive to reduce emissions, while industries in other regions with higher carbon pricing are forced to shoulder higher costs. With common prices, low-cost reductions occur first across the country, with higher-cost ones occurring only as the carbon price rises. Second, if differences in carbon prices exist across regions they should be small enough that businesses do not see their competitiveness challenged by rivals in neighbouring jurisdictions with lower carbon costs.

3. A pan-Canadian carbon price that rises over time. A broad-based carbon price of $30 per tonne can lead to a reduction in GHG emissions, but it will not be high enough to generate the scale of reductions most climate scientists think are necessary over the next several decades. There is plenty of debate over how high prices need to be to achieve Canada's current emissions target for 2030, but values of $125 per tonne or higher are pretty standard. To achieve even deeper reductions by 2050, the carbon price will likely need to rise even further.

4. Well-designed complementary policies. For reasons of cost-effectiveness, carbon pricing should be used to generate most of the emissions reductions. But even strong advocates of carbon pricing (like the Ecofiscal Commission) agree that some other policies will be needed. Selected parts of the economy, such as agriculture and process (noncombustion) emissions in some industries, might require the use of nonprice regulations to drive emissions reductions. Yet there is a concern here as well. Even though it is rarely transparent, all policies of this kind impose economic costs — they have "implicit" carbon prices — and policy-makers should ensure that only well-designed and low-cost policies are implemented.

These are four key *economic* elements for an efficient climate policy for Canada. How about the *political* considerations? At the Ecofiscal Commission, we do our best to stick to economic analysis, avoiding political issues for which we freely admit we have little or no expertise. Yet practical policy-making in Canada requires two further elements to be added.

5. The federal and provincial governments need to work together. Policy-making in Canada usually requires the federal and provincial governments to work together in a constructive manner, not least because of our system of "fiscal federalism." For environmental issues, this need is even stronger, as this is a shared jurisdiction between the two levels of government. The federal and provincial governments have both the right and the responsibility to implement policies for the protection of the environment.

6. Carbon-pricing revenue should remain where it is generated. In a country with a well-established system of fiscal equalization, some will argue that there is nothing wrong with carbon revenues flowing from one province to another, or from one provincial government to the federal government. Yet the central point of carbon pricing is to reduce GHG emissions in an efficient manner — not to increase the scale of government or to redistribute resources across the country. If carbon-pricing revenues are not constrained to remain in the province whence they came, the entire policy framework could easily become a flashpoint for a very different, and highly charged, debate. To keep the focus on carbon pricing as a cost-effective means of reducing GHG emissions, the associated revenues should stay where they are generated.

Having laid out these six elements of an efficient and practical climate policy, it is time to ask how Canada's emerging climate-policy landscape has been affected by the October 3 announcement by Prime Minister Justin Trudeau.

First, the prime minister's announcement clearly indicates that by 2018 there will be a carbon price in every part of the country. As of next year, four provinces will have their own broad-based carbon prices,

but the federal announcement ensures that the remaining gaps will soon be filled. In addition, the federal minimum price of $10 per tonne in 2018 will rise to $50 by 2022. Though it was not explicitly stated, the proposed trajectory, if followed for the subsequent eight years, would take the pan-Canadian (minimum) carbon price to $130 per tonne by 2030. The announcement achieves point #1 above — although we note that no mention was made of the fraction of each province's total emissions that would need to be covered by the carbon price. On point #3, the carbon price is clearly headed in the required direction.

The announcement also states a clear preference for provincial policy action; only if a province fails to implement a carbon price by 2018 will the federal government step in to do so. In addition, provinces are given flexibility in how they achieve their own carbon price — they can choose between a carbon tax and a cap-and-trade system. If they choose a carbon tax, their tax must at least equal the federal minimum; if they choose a cap-and-trade system, their cap must be set to drive provincial emissions reductions at least proportional to those implied by the national 2030 target. Further, the announcement emphasizes that, in the event the federal government implements a carbon price within a jurisdiction, the associated revenues will remain within that jurisdiction. The federal announcement thus achieves important elements of point #5 and it achieves point #6 entirely.

The prime minister's announcement appears to take a lesson from experiences in Canada and other countries that suggest that giving the electorate time to directly observe how a well-designed policy works in practice will help remove the fear of the unknown and build support for a carbon price that rises over time to a level required to achieve the federal government's stated target for 2030. Point #3 is therefore only partly achieved in the short term; but the government's promise to review the policy landscape in five years provides an obvious opportunity to announce a more ambitious price path.

There is also no indication in the announcement of what will be done to prevent large differences emerging between the carbon prices in various jurisdictions. This is a serious issue, and all governments should be encouraged to think carefully about how to prevent such cost-increasing price differences. One possibility is for provinces and territories to allow their emitters to engage in inter-regional trade of emissions permits and/or pollution offsets. Common access to such markets would quickly drive carbon prices to equality across provinces, thus reducing the overall Canadian cost of achieving a given amount of emissions reduction. The absence of any recognition of this issue in the announcement means that point #2 is not yet achieved.

The federal announcement was focused on the need for carbon pricing and understandably did not mention the role of complementary policies; a subsequent announcement indicated that more policies would soon be announced. It is worth mentioning that, if the federal minimum carbon price continues along its planned trajectory beyond 2022 and reaches $130 per tonne by 2030, there would be much less need for additional, nonpricing policies aimed at reducing GHG emissions. In any case, no advance on point #4 was made with the prime minister's announcement.

Finally, some commentators have argued strongly that the nature and timing of the federal announcement, occurring during the middle of a planned meeting of all environment ministers, represented unconstructive political engagement and thus violated point #5. Others disagree, arguing

that the federal government had been actively engaging for many months and that the time had come to act. We take no position one way or the other, as we lack inside knowledge of the complex federal-provincial discussions — and also recognize that what we see in the press coverage may not be an accurate portrayal of the ongoing process of negotiations.

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The climate-policy landscape has progressed remarkably in Canada over the past decade. In 2006, there was no prospect of a broad-based carbon price in any part of the country. By earlier this year, British Columbia had eight years of experience with a carbon tax, Quebec had a two-year-old cap-and-trade system, and Alberta and Ontario were each in the midst of designing their own carbon-pricing systems. In addition, Manitoba had recently announced its commitment to implementing some form of carbon pricing. Despite this considerable progress, however, important policy gaps existed.

With the October 3 announcement by the federal government, the policy gaps will be filled by 2018, the minimum carbon price will be on an upward trajectory until 2022, and the provinces and territories will have considerable flexibility in how they choose to implement a carbon price. In addition, all carbon-pricing revenues will remain where they are generated, thus preventing carbon pricing from morphing into a potentially contentious policy redistributing resources across the country. All of this is an enormous achievement.

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Yet important work remains to be done, and it will require governments to continue working together in a constructive manner to produce a cost-effective policy framework that achieves substantial reductions in GHG emissions. At some point in the near future, the federal government should clarify the path of its minimum carbon price beyond 2022, as well as the share of emissions to which the price will apply — not least so that Canadian firms can be more certain of the economic environment in which they make long-lasting investment decisions. All governments need to recognize the significant costs that arise with significant carbon-price differentials across jurisdictions, and think carefully about how prices can best be aligned. Governments also need to think carefully about which nonpricing policies they will need to complement and enhance the functioning of their carbon prices. None of this is easy; all of it is necessary.

All things considered, the prime minister's October 3 announcement on carbon pricing represented a significant advance for Canadian climate policy. The various parts of the federal plan, as well as the pieces of the puzzle yet to be completed, reveal the difficulties in a federal system of designing policy that is both economically smart and politically practical.

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The authors are all economists and members of Canada's Ecofiscal Commission. This piece was originally published in Policy Options on October 24, 2016.