

Carbon Pricing with a Practical Canadian Twist

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From Alberta to Nova Scotia, and especially in Ontario, spring has ushered in fresh discussions about climate policy. Today, Canada's Ecofiscal Commission (which I chair) released a new report, *The Way Forward*, with specific recommendations for how Canadians can make real progress in reducing greenhouse-gas emissions. The report's two main recommendations will be surprising to many people, but for quite different reasons.

The first recommendation is that carbon pricing rather than regulations should be used as the main tool for reducing GHG emissions. This may surprise people who are less familiar with the details of how markets function, but it is standard fare to anyone well schooled in economics.

The second recommendation is that carbon pricing should be pursued with each Canadian province introducing its own system. This won't surprise those who acknowledge the important role provincial policy has always played in our federation, but it will surprise many economists who see it as violating a central principle.

Before explaining these recommendations, note that each is grounded in the essential concept of "differences". Different firms in different industries all have different cost structures. In particular, they have different abilities to reduce their GHG emissions. And Canadian provinces differ markedly in their economic structures, energy mixes, and emissions profiles. These differences lie at the core of understanding why provincial carbon pricing makes so much sense for Canada.

Let's begin with why carbon pricing is better than a regulatory approach. When regulations are used, governments dictate to specific firms and sectors how much to reduce emissions. This might reduce emissions successfully, but it is unnecessarily costly because governments lack the knowledge enabling them to allocate more reductions to those firms who can most easily achieve them. In contrast, when carbon pricing is used, all firms are faced with an economic incentive to find the most profitable, low-cost way to reduce emissions. Some firms will reduce emissions a lot and others less, but the result for the overall economy is that emissions reductions occur at the lowest possible cost.

A second advantage of carbon pricing is that it generates revenues that governments can "recycle" back into the economy to produce important economic benefits. There are many recycling options, from income-tax cuts to financing infrastructure to investing in R&D, and Canadians need to hold their governments to account for choosing the best method. But regulations provide no scope for these kinds of benefits.

Now consider why Canadian carbon pricing can be done most practically by the provinces. Many economists will be surprised because this approach will yield different carbon prices

in different provinces, and thus some efficiency of the policy will be sacrificed. They are right, but they're also missing something important – something not usually emphasized in the economics textbooks.

In Canada we should never forget the importance of provincial differences – in economic structures, energy mixes, and priorities. These differences need to be built into each province's carbon-pricing system in order to make it appropriate for the realities on the ground. Importantly, if the carbon-pricing revenues are kept within the province, they can be used in ways that most satisfy the provincial economic and political priorities. It is no surprise that the three existing carbon-pricing systems, in British Columbia, Alberta, and Quebec, are all designed very differently, including different approaches to revenue recycling.

The Commission recommends that provincial carbon-pricing systems should eventually be aligned in order to generate a consistent carbon price across Canada, thus maximizing the country's economic benefits. But its analysis also shows that the lion's share of the benefits from carbon pricing comes from independent provincial action. Provinces don't have to wait for anyone or anything; they can put carbon-pricing systems in place now and start making meaningful reductions in greenhouse-gas emissions. The desire for eventual alignment need not be an obstacle for current action.

Canadians overwhelmingly want to make progress on climate policy, but many are unsure how to move forward. And though their provincial governments have each adopted emissions targets for 2020, these targets will very likely be missed. So there is a clear need for more policy action. What to do?

The Commission's recommendation for provincially based carbon-pricing policies is well grounded in sound economic principles and also in the practicalities of policymaking within the Canadian federation. *The Way Forward* offers both an optimistic and realistic approach for all Canadians to make real progress on the crucial issue of our time.

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