

## Four Things Ontario's Cap-and-Trade System Must Get Right

By Paul Boothe and Christopher Ragan

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This week, Ontario Premier Kathleen Wynne made a major announcement in the battle against climate change: Ontario will join Quebec and California in a “cap and trade” system to limit greenhouse-gas emissions. This is an important continuation of the trend to using carbon pricing to cut such emissions and Ontario’s decision to move ahead represents a very positive step forward for Canada.

But there is still plenty of work to do regarding implementation. As emphasized in a [new report by Canada's Ecofiscal Commission](#), when it comes to carbon-pricing policy, details matter. The actual design of the system will determine whether Ontario’s cap-and-trade system will be effective in limiting emissions, and if it will do so in a cost-effective manner. Both are crucial. So it is worthwhile examining some characteristics of an effective cap-and-trade system. Here are four central design characteristics to look for as the implementation work begins:

**The first is broad coverage.** If cap-and-trade systems are limited to a small number of large emitters, many emissions in the province will be missed. Narrow coverage tends to be less effective at reducing overall emissions and also, because it places the burden on a small number of emitters, it tends to be more costly than necessary. In addition, leaving some sectors outside of the system is needlessly divisive. In order to improve cost-effectiveness, and also to encourage all Ontarians to recognize that they are joined in a common project, the system should be designed with the widest possible coverage. Quebec’s system covers roughly 85 per cent of its emissions; Ontario should aim to match that coverage.

**The second characteristic is increasing the system’s stringency over time.** The overall limit on emissions (the “cap”) needs to be stringent enough to actually reduce the province’s overall carbon emissions. Over time, the cap should become more stringent, which means a gradual reduction in the permissible amount of emissions. Political leaders should aim to balance the need to get significant emissions reductions with the costs of adapting the economy to a new, lower-carbon future.

**The third characteristic of an effective cap-and-trade system relates to how the tradable permits are allocated.** Permits lie at the heart of any cap-and-trade system. When these systems have foundered in the past, it has usually been due to a combination of insufficient stringency (too many permits) and the government allocating the permits in an inefficient way. One example of ineffective allocation is to give away permits for free to existing emitters. Although this obviously pleases the lucky emitters, it leaves the government open to the charge that they are playing favourites, and undermines the political acceptability of the policy.

An efficient and transparent approach to allocating permits uses an auction. Emitters bid for allowances based on their own particular costs of cutting emissions. When the cost of reducing

emissions is higher than the cost of buying permits, they will bid. When the cost of cutting emissions is less than the cost of permits, they will reduce their emissions. If the cost of reducing is less than the cost of permits, emitters can also bid for permits and trade them to emitters with higher costs – thus helping to ensure that the province’s overall emissions reductions occur at the lowest possible cost.

**The fourth characteristic to watch for is how the government recycles the revenues generated by the cap-and-trade system.** Of course, if all the permits are given away for free, there is no revenue generated. But if those permits are sold at auction, the government needs to decide how best to use those revenues. There are many options, from reductions in corporate and personal income taxes to investments in public infrastructure to support for clean-tech or even for general research and development. This is not an easy choice, but Ontarians need to hold their provincial government to account for developing a transparent system of recycling the revenues in a way that generates genuine economic benefits for the province.

There is no question that Ontario’s announcement is a big step forward in improving Canada’s contribution to global efforts to reduce greenhouse-gas emissions. And Premier Wynne and her cabinet should be applauded. Turning that announcement into an effective cap-and-trade system is the next step in the journey. All Canadians, but especially those living in Ontario, have a stake in seeing that the important design work is done well.

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