<u>The Good News and the Bad in Ontario's New Climate Legislation</u>

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You may be surprised to learn this, but economists are not the same as "normal" people. The main difference relates to how the two groups think about markets and prices. Most people, including elected politicians, don't think much about the workings of markets and prices. This is a serious problem when it leads to the adoption of poor public policies.

Consumers think about the prices of the goods and services they consider buying. A high price for some product makes them consider alternatives; a low price increases the likelihood they purchase it. Business managers think about prices as ways to cover their costs and generate profits. Higher prices make a venture more attractive; lower prices reduce returns and suggest a search for alternative investments.

Economists share these general views of prices, but usually focus on what is going on far beneath the surface. Dating back to the late 1700s and the writings of Adam Smith, economists see the entire "price system" as an essential and largely automatic mechanism for ordering society and for allocating scarce resources.

When demand for some product rises, producers are induced to bring forth greater supply only when the price increases and enhances profitability. When supply for some other product collapses, consumers are led to economize only because the associated price increase drives them to substitute toward other products. This market coordination happens without an overall economic plan—either from government or anyone else.

Since politicians are most often "normal" people, they often design policies without placing much emphasis on markets and prices. Rather than seeking out ways to achieve their objectives by harnessing the power of markets, policymakers usually suggest direct government intervention—either regulating outcomes or spending public dollars.

Regulations are intuitive for most people because telling firms and households how to behave sounds like an obvious solution to a problem. If the objective is to reduce GHG emissions by having more fuel-efficient vehicles, policy can force auto-making firms to redesign their fleets or force fuel companies to blend gasoline with biofuels. What could be simpler?

Using public money to support specific sectors is also very intuitive for normal people. If we want a larger clean-tech sector, why not directly inject public funds? If we need more renewable power, why not provide generous subsidies to induce the needed supply? These actions sound sensible to most people.

The main problem with both approaches is that they're rarely the lowest-cost way to achieve the stated objectives. Since firms differ in their costs of reducing GHG emissions, and in ways that government can rarely know with precision, most across-the-board regulations are very costly for the economy.

Public subsidies are no better, and often worse. Not only does the process involve picking winners and losers, which quickly becomes a divisive political game, but many subsidies pay households or firms for actions they were going to take anyway. As a result, they are fiscally very expensive.

If the objective is to reduce GHG emissions and increase the supply of renewable energy, there is a far better policy option. The least-cost approach is to put a serious price on GHG emissions. The market participants can then figure out who will reduce emissions and by how much, and also the best kind of renewable energy to develop, and how to do it. With a well-designed carbon price, many government regulations and subsidies are simply unnecessary.

This brings us to Ontario's new climate legislation. The good news is that the Ontario government is implementing a cap-and-trade system that puts a price on GHG emissions. It will start at about $18 per tonne in 2017 and rise gradually over time.

The bad news, at least according to what was leaked to the Globe and Mail last week, is that the Ontario government doesn't seem to really trust its carbon price to succeed, and so it couldn't resist the very human temptation to create a whole raft of regulations and subsidies, most of which will be unnecessary or costly, and probably both.

Canada faces considerable challenges with respect to its long-run economic growth, and our governments need to be especially mindful of whether their climate policies achieve the objectives in the most cost-effective manner. On this front, the latest news from the Ontario government could have been a lot better.

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