

Common Ground: A New Framework For Canadian Energy Policy and Kyoto

by

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I want to thank the Canadian Club of Calgary for giving me this opportunity to address you on a subject of great importance, not only in this province, but in Canada as a whole: that is, the future of our Canadian energy industry.

At no time since the early 1980s has Canada faced energy issues that could have such critical ramifications for the country's economic and political future. As many of you in this room will recall, Canada undertook a set of policies under the National Energy Program that were designed to shield consumers from price increases. Those policies were a monumental failure and they angered and alienated Western Canada, leaving wounds that all these years later have not completely healed.

We are now at a similar juncture, facing challenges that could lead to either of two results — depending, to paraphrase the great poet Robert Frost, on which of two roads we decide to take. One road leads to a better Canada with a smart framework for energy policy and an environmentally sustainable, thriving energy industry making significant contributions to the country's economic performance.

The other road leads to a worsening economic performance for Canada: shrinking energy supplies, unnecessarily high costs for consumers and businesses and a less competitive country overall. Wrong-headed energy policies only undermine Canada's standard of living and, with incomes falling behind those of other industrialized countries, Canadians will increasingly resist and resent supporting social and environmental programs.

Four specific issues are most critical to the future of this country's energy industry. They are:

- Canada's relationship with the United States after September 11, 2001.
- The competitiveness of our industry in providing secure sources of energy for Canada and its foreign partners and the role of the federal government in fostering that "edge."
- Pressing environmental concerns, including global warming and the Kyoto Protocol.
- The role of the consumer in stimulating energy efficiency and profitability.

I'd like to briefly discuss these concerns to illustrate their relevance for energy policy in Canada.

But first let me say that I believe that the federal and provincial governments must develop a set of consistent, coherent policies that provide a clear direction for energy development. Unfortunately, I see no sign of such discussions unfolding. I hope to help shed some light on a potential framework that would help get talks started and help move us into the future with a sustainable energy-development policy.

September 11, 2001: Access to US Markets

It's important to remember, if any of us need reminding, that the context in which we are examining these issues is the aftermath of September 11, 2001. It was not long ago that Canadians felt very vulnerable when terrorist activities resulted in horrible destruction

and loss of life in the United States. The United States, concerned over its security, could have made it very difficult for Canadians to trade with and travel to the United States.

Two-way trade with the United States is worth as much as \$1.5 billion or \$50 per person every single day of the year. That trade — we can't forget that a whopping 85 percent of our exports are now sold in the United States — provides a significant economic advantage for Canada, creating high-paying jobs for many of our citizens.

The economic loss for both countries would be severe if trans-border trade had been permanently interrupted. After all, no one should overlook the often-ignored fact that Canada buys as much as 22 percent of all US exports, far in excess of any other country. A major disruption of cross-border trading patterns would lead to the loss of hundreds of thousands of jobs, while border-crossing closures, or other travel restrictions, would isolate those in both countries from friends and relatives living in the other.

Luckily, both the Canadian and US governments swiftly recognized the inviolability of the border with the Smart Border Declaration, freeing the movement of goods, services and people after relatively brief disruptions. This trust and co-operation between two friendly countries sharing much of the North American space is a shining example for other countries looking for economic advantages from trade.

Still, despite our progress, many irritants remain to be resolved if the United States and Canada are to improve their economic ties and achieve closer integration. Canada wants

procedures and rules that ensure access to US markets without facing unfair restrictions, as in the case of softwood lumber. The United States wants greater access to Canadian technology and trade.

Further, as businesses become increasingly North America oriented, rather than focussed on only one location for their trade, many Canadians and Americans have to work in both countries and don't want to face undue bureaucratic red tape. The United States wants to ensure both that its borders aren't vulnerable to terrorists and that it has access to the secure sources of critical supplies that make the US economy hum.

It is this latter point that brings us to energy. The United States wants energy supplies that cannot easily be disrupted by unfriendly countries. Even though the United States and other consuming countries cannot shield themselves from price shocks, Washington wants to ensure that the energy will actually land on its shores from secure sources.

Canada is, of course, an important and secure supplier of energy to US markets, a friend that the Americans can count on during a period of energy shortages. Unfettered today from the burdensome regulations of the past, Canadians sell vast amounts of energy — oil, natural gas, coal, electricity — that provide an economic advantage in our relations with the United States. Both countries gain economically and politically from the strong friendship on both sides of the 49th parallel.

Competitiveness and Energy Supplies

Here, the question is whether Canada is able and willing to provide secure energy supplies to the United States. Is our energy industry sufficiently competitive that Canadian producers will be able to sell energy to the United States and other trading partners? Or will our trading partners have to rely on cheaper sources of energy that might come from less secure countries in the Middle East and Russia?

In oil, Canada has rich supplies in the oil sands that can provide secure energy for many years, while conventional crude oil is getting harder to produce. Production costs are also rising for tar-sand production, however, so competitiveness is a concern for many energy companies.

While many costs — whether land rents or salaries — are issues that must be dealt with by producers, some are related to government policy.

The most important competitiveness issue that has lingered for almost three years now is the corporate tax issue, arising from the federal 2000 budget. The federal government, following the report of the Technical Committee on Business Taxation, is lowering corporate income-tax rates for businesses from 28 percent to 21 percent, the current rate applying to manufacturing and processing income. Companies with resource profits were not provided a similar reduction. Instead, the government announced it would discuss with the resource sector a new framework that would provide lower corporate income-tax rates with a new package of incentives.

Much to my regret — I chaired that committee — the government failed to take a balanced approach across all sectors in the economy by cutting back some incentives that would have provided greater revenue, while reducing corporate income tax rates for all businesses. This was the approach taken by the Australian government after the Ralph report was presented, itself fashioned after the Canadian report. The only difference is that the Australian government cut corporate income-tax rates quickly and reduced some inefficient tax incentives, without discriminating among sectors.

By contrast, the Canadian government selectively chose the resource sector for the rate-reduction/base broadening approach. As I wrote in a *C.D. Howe Institute Backgrounder* in the spring of 2001, I believe this system reduces Canada's competitiveness and is unfair.

To improve competitiveness, I believe that Ottawa should treat the resource industry like every other sector of the economy. As I said in the spring of 2001, three important changes are needed:

- The federal corporate income tax rate on resource profits should be reduced to 21 percent from 28 percent, consistent with other business activities. With Alberta and Ontario eliminating differences in corporate income tax rates across business activities, Canada will move to a simpler corporate income-tax system that is more easily complied with, as is the case in most other countries.

- Like other taxes and fees, non-renewable resource royalties should be deducted from profit, instead of providing what is now an antiquated and complex resource allowance in lieu of royalty deductibility. This one change in the base would have a profound effect in simplifying the resource-tax system today.
- Similar to the research and development tax credit, a tax credit for exploration and development should be provided for resource companies. The credit could be made partially refundable for smaller producers and the complex and economically costly flow-through share provisions could be eliminated.

These three changes to the corporate tax system would put resource companies on an equal footing with other industries. For the government, however, the change would result in a substantial reduction in corporate tax revenue collected from the industry as a whole.

I would still argue that a tax reduction on resource investments would be appropriate. As I have shown in my own earlier work, the resource industry, like so many of our industries, faces higher taxes as a cost of doing business in Canada than is the case in the United States.

Since I have been a proponent of Canada avoiding excessively high taxes on investment for all industries, I am not at all troubled by changes to the taxation of the resource sector that would improve competitiveness and productivity. Total government taxes and other

revenues, now 42 percent of GDP, are high by historical and international standards. Reductions are appropriate.

If Canada is to provide secure sources of energy to North American markets, the taxation issue should be finally resolved in the next federal budget. The industry needs a stable, efficient and simple system if it is to develop secure supplies in the North American market.

Global Warming and the Kyoto Protocol

The taxation issue, in my view, can be settled in a fairly straightforward manner. Far more complex is the current commitment by the Prime Minister to ratify the Kyoto accord. The question that all Canadians should ask is how does this fit with the need to provide secure energy sources on a competitive basis?

Perhaps, it would be useful to understand the meaning of the Kyoto Protocol before answering this question. For this purpose, I prefer to start with what Kyoto is *not* about since there is so much confusion about its real objectives.

Kyoto is not about smog in Toronto or Vancouver, which is related to sulphur dioxides and nitrogen oxides. It is true that if we reduce consumption of oil and coal, we could help reduce smog in concentrated urban centres. But Kyoto is not about this type of pollution. Instead, the agreement encourages the reduction of greenhouse gases — carbon dioxide, methane, water vapour and others — that are believed to cause global warming.

Thus, for example, the consumption of natural gas should also be reduced to cut back greenhouse gas emissions, though it would be considered a “clean” energy if smog were the only concern. It is important for Canadians to understand what is trying to be achieved.

Second, the Kyoto agreement is not about introducing new technologies to reduce greenhouse gas emissions. If such technologies are arguably profitable now, we do not need to ratify the agreement to put them in place. Governments can support even those non-profitable technologies that reduce the social cost of greenhouse gas emissions without ratifying the Kyoto agreement.

So what is the Kyoto agreement about? The agreement is an international one that encourages joint action by countries to reduce greenhouse gas emissions. Joint action is sought by allowing countries to receive credits for supporting actions of other countries to reduce or avoid increasing their emissions. The most important mechanism is the trading of credits that would enable an industrialized country to avoid targeted actions to reduce emissions by purchasing so called “hot air” from former Soviet and other central and Eastern European countries that currently have emissions below targeted amounts.

The only countries that are committed to reductions in greenhouse gas emissions below 1990 levels are those that signed Annex B: they include industrialized countries and transition economies. Developing countries can ratify the agreement but are not committed to a target for emission reductions. Canada agreed in 1997, on the basis of

very little research, to a reduction of six percent in emissions from 1990 levels by 2012. Based on a forecasted business-as-usual emission rate, Canada would need to reduce emissions of greenhouse gases by about 240 megatonnes of carbon dioxide, or almost 30 percent of total emissions expected in 2010.

At present, no penalties are applied to countries not complying with ratified targets. Some believe Canada will simply avoid implementing the protocol after ratification since no penalty would be paid for non-compliance. I believe such action is inappropriate. Either we do our best to fulfil our commitments, or we shouldn't make the commitment in the first place.

So far, the United States and Australia have indicated that they will not ratify the agreement. With these two countries and the developing states excluded, almost two-thirds of worldwide emissions will not be subject to targeted reductions.

Part of the difficulty in assessing whether Canada should go ahead is that we do not have a detailed plan at this point. Unlike the free-trade debate, when the agreement was in front of us and there were many economic studies with different approaches to analyzing the benefits and costs, the discussion on the Kyoto agreement has taken place in an atmosphere of intrigue and little understanding.

The federal discussion paper has estimated the economic costs for two options to fulfil the Kyoto agreement are relatively small. **While the energy modelling is well detailed, the remainder is based on a macroeconomic approach** with few dynamics, no market-price determination and limited modelling of investment behaviour. Other approaches that provide for a better characterization of market behaviour and investment modelling are commonly used in other countries. And other types of modelling are needed for a more complete understanding of implications of Kyoto to confirm or deny the limited information that we have.

Also problematical is the absence of details needed to estimate costs of the plan. Some laudable targets, such as increasing fuel efficiency by at least 25 percent and targeting 20 percent of houses and buildings with energy retrofits, are difficult to assess in terms of their true costs.

For example, would retrofits be legislated or will tax incentives be provided? If tax incentives are used, the cost could be quite high if they are not well designed or if energy-efficient building prices rise, capturing a significant share of the tax benefits. Canada could fail to achieve its goals for emission reduction, or achieve them at high cost if programs are not well designed.

In some cases, it is impossible to assess the costs because some goals have no plans yet. One clear example of this is the reference to households reducing their energy needs by 20 percent through changes to lifestyle.

I'd like to make just a few other observations about Kyoto before I wrap up my remarks.

It seems clear that other countries will not recognize Canada's claim for clean energy exports to the United States. Either we claim them unilaterally or we find other means of achieving the target.

And, unlike Europe, Canada has a growing population. Strict adherence to targets based on total emissions, not per capita emissions, penalizes those growing countries that are accepting relatively large immigration flows, while those that lose population will find it easier to comply with Kyoto over time.

With the United States and Australia not ratifying the accord, Canada should consider whether it would be better to follow a made-at-home plan, like the Americans and Australians. Without sufficient details on implementation and costs, this is a difficult choice to make. We don't even know what a made-in-Canada plan would like, never mind one that tries to achieve the Kyoto targets.

So let me try to outline the differences between a made-in-Canada approach and ratification of Kyoto, neither of which we understand at this point. Four specific issues are worth mentioning.

For one thing, if we did not ratify Kyoto but had our own plan, Canada would not be part of the tradable permit system at the international level. Under the proposed second part of

the current action plan, ratification of Kyoto calls for only a reduction of 10 megatonnes of CO₂ through purchases of international credits, since most other actions can be taken without ratification. Purchasing permits might be cheaper than undertaking our own actions, although there may be enforcement problems to make sure transition economies with excess credits are truly reducing their emissions. Depending on the traded price of carbon that will ultimately depend on the emission of transition economies, with Russia indicating it is not prepared to ratify yet, the cost could vary widely. Thus, we are not certain as to whether the international permit system will be an advantage to Canada.

For another thing, with our own plan, Canada would not be signatory to an international agreement promoting joint action over greenhouse gas emissions. While Canadian emissions, about two percent of worldwide emissions, are too insignificant to make a difference to global warming, or to ratification for that matter, we would be acting contrary to our usual foreign policy stance of supporting international co-operative efforts if we chose to go it alone. However, as anyone knowledgeable about game theory knows, countries should never participate in agreements if they are worse off with the agreement than without it.

Third, the Kyoto agreement would require actions to take place by 2012 to meet our targets. With the adoption of our own plan without ratification, we could choose our own timeline without trying to implement measures according to the Kyoto schedule that we agreed to in 1997.

Fourth, with the United States undertaking its own plan, we could design ours according to the details and timing of our neighbour's approach. This does not mean blindly following the United States; it does mean that we could better account for competitive issues by taking more time in developing our own schedule, rather than following Kyoto's committed reductions. Since most of our competitors, including the United States and Mexico, do not have to commit to targeted reductions in emissions, then actions taken here for some industries could be offset by actions taken elsewhere, with little or no impact on worldwide emissions.

In principle, I would favour ratification of Kyoto in order to encourage international joint action. But with the current target and timelines that were poorly researched in 1997, I see ratification at this point as a costly mistake. It seems at this juncture it would be better to adopt a Canada-made plan with its own target and emissions.

Conclusions

Let me now try to quickly bring my themes together. We are concerned about security in North America and the contribution that energy makes in this regard. We want to ensure that Canada's energy industry is competitive as a supplier without losing investments to other countries. And any commitment to reducing greenhouse gas emissions should be based squarely on security and competitiveness concerns.

Environmental concerns over global warming and other issues like smog could be consistent with security needs if the impact of policies is to reduce consumer demand for

energy. To reduce demand, however, I know of no better way than to let prices rise.

Given current projections for reserves and production, a likely outcome is that prices for oil and gas energy supplies shall indeed rise over time.

The real issue is the following: are Canadians willing to accept higher energy prices to deal with environmental and security issues?

Letting prices choke off demand is contrary to public sentiment at this time in Canada. Ontario has just announced protecting consumers from electricity price increases for the next four years. Even Alberta, appropriately critical of the National Energy Program for protecting consumers from higher energy prices, provided a rich payment to its residents to offset higher electricity prices two years ago.

The challenge to Canadians in general is whether they wish to continue to consume energy at rapid rates or meet environmental objectives. I believe there is room to accommodate political, economic and environmental objectives — but we must be realistic — required change in consumer behaviour is substantial, not small as often professed.

Canada can have a strong energy industry in the future while dealing with security, competitiveness and environmental concerns. A policy framework should be based on achieving all three goals rather than concentrating on solely on any one of them. Let's

encourage our governments to spell out a common energy policy. That may be choosing, like Frost, a road less traveled, but at least it's one we can all follow.