Intelligence MEMOS

From: Glen Hodgson

To: Canadians Interested in Economic Competitiveness

Date: January 31, 2023

Re: **HOW SHOULD CANADA RESPOND TO THE US *INFLATION REDUCTION ACT*?**

The reality of climate change and the imperative to reduce GHG emissions is now being addressed by policymakers in many countries, most notably in new comprehensive US legislation.

The *Inflation Reduction Act* (IRA) is exceptionally broad legislation aimed at numerous simultaneous goals, little of which deal with inflation. Instead, its centerpiece is a wide-ranging framework for US climate policy, the nation's largest ever initiative to address climate change. The Act promotes a low-carbon economy by providing numerous fiscal incentives for clean energy use, notably investment in near-zero-emission electricity production among other initiatives.

Expensive tax credits and subsidies are its main tools to shift consumer behaviour, influence business decisions, and thereby reduce emissions. Their total cost has been estimated at nearly $400 billion by the non-partisan Congressional Budget Office. Analysis by Credit Suisse suggests the bill could be twice as high, since many of the tax credits are open-ended and there is no spending cap in the legislation. Relying heavily on subsidies is a less economically efficient approach to guiding the energy transition than putting a price on carbon.

How should Canada respond?

Ottawa does not have to follow the US on fiscal incentives. It can set priorities and focus on the areas of greatest risk to the Canadian economy, and greatest opportunity.

A selective and targeted strategy can be applied to simultaneously reduce emissions and support economic growth – including in areas like clean energy investment, the development of clean tech, and key enablers like green finance. Fiscal resources can be focused, matching the IRA subsidy approach where required and taking other action that reflects Canadian priorities.

I propose five key objectives for governments to consider. The goal is to maximize economic benefits while reducing emissions, with the right policy tools in the right places.

Objective 1: Promote clean investment. Canada should focus on measures that promote investment here in clean energy and strategic inputs as a top priority, minimizing any deflection of such investment to the US. A new refundable investment tax credit for carbon capture, utilization, and storage (CCUS) was put in place last year. Direct air capture, which is not included under the IRA, is also eligible for the credit.

As well, the 2022 Fall Economic Statement confirmed that a refundable tax credit equal to 30 percent of the capital cost of other clean tech investments will be available on the day of Budget 2023. It will be available for innovative electricity generation and storage systems, low-carbon heat equipment, and industrial zero-emission vehicles and related charging or refueling equipment. These applications all make sense as investment priorities.

Objective 2: Maintain US market access for clean exports. Being able to seize future clean export opportunities is an obvious priority, but exports subsidies are generally not permitted. Fortunately, the IRA shows that Canadian advocacy to maintain US market access for clean exports have so far succeeded. The IRA tax credit for new vehicle purchases extends to Canada and Mexico as NAFTA2 partners, as long as a significant share of batteries and key components is extracted or processed in any of the three nations.

Objective 3: Secure Canada's place in regional (and global) supply and value chains that eliminate or reduce emissions. End products such as green vehicles get most media attention, but key emission-reducing inputs, notably batteries, strategic minerals, clean tech, and vehicle and aircraft parts are also important, along with supply chain management and innovation capacity. It would be smart policy for Canada to respond to IRA programs by using targeted tax credits for investment in these key inputs that help to reduce or elimination emissions.

Objective 4: Use the best policy option. The IRA relies heavily on pricey tax credits and subsidies. It does not implement carbon pricing, which is more economically efficient, does not draw on government budgets, and is more transparent than subsidies. A detailed pan-Canadian carbon pricing framework is already in place. If set at the right level, carbon pricing can be relied upon to shift consumer and business behaviour with little need for open-ended tax credits.

Objective 5: Engage with the provinces in specific policy areas. A coordinated response is needed to meet US competitive challenges in sectors where there is shared jurisdiction or provincial primacy in Canada, and Ottawa should initiate that effort.

The federal government's tax credits in Budget 2022 were well-targeted and will help level the playing field for investment in carbon capture. We need more of the same precision in Budget 2023.

Glen Hodgson is a fellow-in-residence at the C.D. Howe Institute.

To send a comment or leave feedback, email us at blog@cdhowe.org.