

An Open Letter to the Leaders of Canada's Federal Political Parties

From economists teaching in Canadian colleges and universities

One of the few issues on which most economists agree is the need for public policy to protect the environment. Why so much agreement? Because in the absence of policy, individuals generally don't take the environmental consequences of their actions into account, and the result is "market failure" and excessive levels of pollution. Environmental degradation diminishes the quality of life for all of us. And without a healthy environment, we can't sustain a healthy economy. We, the undersigned, have therefore joined together to express our shared views on effective policies to address climate change.

We are non-partisan and will undoubtedly be supporting different parties in this election. Our goal is not to criticize or praise one party or another, but rather to offer our collective views, as economists, to help inform public debate on these matters at a critical time – during a federal election campaign.

What Needs to be Done

While Canada clearly cannot solve the climate change problem on its own, we need to do our part, and this requires immediate and substantive action by our federal government. We make this statement fully acknowledging the importance of other issues to Canadian voters, such as the turmoil in financial markets and our military involvement in Afghanistan. But climate scientists state that we bear the costs of our lack of action on carbon reduction on a daily basis, and within a few decades the impacts of climate change could be truly catastrophic—unless we take action now. Even those who are not quite convinced by today's scientific evidence need to consider the costs of not acting now. If they turn out to be wrong, and we wait for complete certainty, it will be too late.

All the major political parties have stated that they understand the need to act on carbon emissions. The question then becomes what action to take. Any action (including inaction) will have substantial economic consequences and, thus, economics lies at the heart of the debate on climate change.

With this letter, we hope to help put the debate on a more solid economic foundation by offering the following set of principles upon which we believe climate change policy should be founded.

- 1) **Canada needs to act on climate change now.**
- 2) **Any substantive action will involve economic costs.** Any effective carbon-reduction policy will necessarily entail changing the way we live and do business. All forms of regulation, taxes, or markets for the exchange of emission permits that have a significant impact on greenhouse gas emissions will affect the prices of carbon-intensive goods.
- 3) **These economic impacts cannot be an excuse for inaction.** Climate scientists are clear on the costs of inaction, and that these costs will accumulate well beyond the current business cycle, possibly at an accelerating rate. Active and effective climate change policy should be seen as an investment that will yield pay-offs for ourselves, our children and our grandchildren. Given the need to act, the question then becomes which policies would obtain the carbon reduction goals we establish with the lowest cost and greatest level of fairness.
- 4) **Pricing carbon is the best approach from an economic perspective.** Approaches to reaching any particular climate change goal that involve pricing carbon, such as carbon taxes and cap and trade systems, involve less economic damage to businesses and families than the alternatives. Carbon pricing is good for several reasons:
 - a) **Pricing allows each business and family to choose the response that is best and most efficient for them.** Firms and families will differ greatly in the options they have for reducing their use of carbon, as well as in the value they place on carbon-generating activities. Price mechanisms give everyone the incentive to reduce their carbon use, but to do so to the degree and in the way that is best for them. This is the main reason that pricing policies are the lowest-cost way to meet our climate change goals.
 - b) **Pricing induces innovation.** As the price of carbon increases, users of carbon intensive goods will demand alternatives. This will induce innovations in the goods and services that are produced, how those goods and services are produced, and the way people live. By moving relatively early in terms of climate policy, Canada has an opportunity to innovate and sell new technologies to the rest of the world.

- c) **Carbon is almost certainly under-priced right now.** In a fully efficient price system, the price we pay for a product would reflect the full costs of producing and using it, including the costs to the environment. Prices do not currently reflect those environmental costs. When carbon is under-priced, consumers and businesses tend to use too much of it. Policies that increase the price of carbon provide the proper incentives for consumers and businesses when they are making their investment and consumption decisions.
- 5) **Regulation tends to be the most expensive way to meet a given climate change goal.** Under regulation, businesses and consumers are mandated to take particular actions related to carbon use (e.g., use a particular technology or stay under mandated levels with no option to trade carbon emission rights). As a result, they are not given the choice of adjusting in the way that is best for them. Regulation therefore increases the costs of achieving carbon reduction compared to when pricing mechanisms such as a carbon tax or a cap and trade system are used. Furthermore, while regulations imposed on firms may appear to be so far removed from the typical consumer that they might think they will not bear these costs, this is not true. Those increased costs will be passed on to consumers due to normal market forces. There may be circumstances when regulation is the appropriate policy tool, but in most cases it is the most economically damaging.
- 6) **A carbon tax has the advantage of providing certainty in the price of carbon.** Under a carbon tax, a charge is added to the sale of all fuels according to the carbon emitted when they are used. With a well-designed carbon tax strategy, the tax will be introduced gradually and increased in pre-announced increments until the environmental target is reached. This provides investors with a degree of certainty that is good for business, and allows consumers to make adjustments knowing what is coming. The exact impact of the price increase on the quantity of carbon emitted can be predicted, although with some margin of error. A carbon tax thus involves choosing price certainty but accepting some uncertainty in total carbon emissions.
- 7) **A cap and trade system provides certainty on the quantity of carbon emitted, but not on the price of carbon and can be a highly complex policy to implement.** In a cap and trade system, an upper limit (cap) is set on carbon emissions, usually for a particular industry.

The government must then make a decision about whether to auction the permits (known as allowances), requiring each firm to buy enough allowances to cover its total emissions. Normal market forces then determine the price of these allowances such that supply equals demand. A cap and trade system with auctioned allowances then acts much like a carbon tax. The price cannot, however, be predicted in advance. Alternatively, the government can issue allowances to firms without charge, then open up the market for trading. In this situation, there is both the uncertainty about the price and potential for significant problems to emerge in the market based on how the allowances are initially allocated. The Emission Trading System in the European Union began by distributing too many allowances and as a result the price fell to close to zero, rendering the policy ineffective. Thus, while a cap and trade system can in principle be equivalent to a carbon tax in terms of its ultimate impacts on the price and quantity of carbon, and will generally give more certainty in meeting environmental targets if the allowances are properly chosen, the price uncertainty in the cap and trade system generally implies a worse environment for long-range decision-making on the part of businesses and consumers.

- 8) **Policies that impose costs on producers (big or small) affect consumers.** Some voters seem to think that policies like cap and trade, which apply directly to producers, have less impact on the prices they face than carbon taxes, where the impact can be seen immediately. In fact, voters would do better to assume that all such policies would, ultimately, affect the prices they pay. Indeed, since the goal of these policies is to change what we buy, policies applied to producers must affect the prices faced by consumers if they are to meet environmental goals. The argument that a policy capable of reducing carbon emissions will only affect producers is without economic merit.
- 9) **Price mechanisms can be regressive and our policy should address this.** Like most taxes on goods and services that are widely consumed, carbon pricing will have a larger negative effect on lower income Canadian families than others. As we have stated, the same is true of regulation since regulation also raises costs of production and those increased costs will ultimately show up in higher prices. Thus, whatever policy is used, a complete policy should include some element of redistribution to address the impacts it will have on the least well off in our society. Not only will the costs to consumers ultimately be lower under a carbon tax or

auctioned emission permits, these latter policies also have the potential to bring revenue into the government that can be used to help offset any inordinate hardship experienced among the least well-off. This is not true of regulatory approaches, or of a cap and trade system in which the allowances are allocated without charge to emitters.

- 10) **A pricing mechanism can allow other taxes to be reduced and provide an opportunity to improve the tax system.** With the revenue brought in from a carbon tax or from auctioning the allowances in a cap and trade system, governments can provide general cuts in income and/or corporate taxes. Such systems can be “tax neutral”, meaning the increased burden of the carbon taxes is exactly offset by tax reductions elsewhere, but this result will depend on the details of the particular policy adopted. Under such a plan, lighter carbon users will tend to pay lower taxes overall, while heavier polluters will pay more, corresponding to their greater negative effects on the environment. At the same time, all individuals will continue to have an incentive to reduce their carbon emissions when prices include the cost of their carbon usage. If the tax redesign is done thoughtfully, Canada could move toward an overall tax system, which imposes fewer burdens on the economy and, as a result, leads to a more productive economy for all Canadians.

In closing, we ask you, the leaders of Canada's major political parties, to immediately begin a substantive public debate, grounded in the generally accepted economic principles outlined above, on the best ways to address climate change. Our collective future is truly in your hands.

[Names and titles of signers]