

## POLICY BRIEF

# Identifying Inefficient Fossil Fuel Subsidies in Canada

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## Introduction

Ending government subsidies for fossil fuels and aligning financial flows with the Paris Agreement targets is imperative to addressing the worsening climate crisis. The most recent report from the Intergovernmental Panel on Climate Change (IPCC) paints a stark picture of the narrowing window for action to transition to low-carbon economies and for high-emitting countries like Canada to take responsibility for leading the way (IPCC, 2022).

Canada first committed to phasing out “inefficient fossil fuel subsidies” in 2009 alongside its G20 peers (G20, 2009) and has consistently reiterated this commitment, most recently in the 26th Conference of the Parties to the United Nations Framework Convention on Climate Change (COP 26) Glasgow Climate Pact and in the federal 2022 Emissions Reduction Plan. In the mandate letters given to ministers last year, the Canadian government has brought forward the commitment to eliminate fossil fuel subsidies from 2025 to 2023, alongside a commitment to phase out all other public financing for fossil fuels (Government of Canada, 2021), indicating increased public and global pressure to align federal economic support with climate commitments. Canada has also committed to phasing out international public financing for fossil fuels this year (United Nations [UN], 2021) and coal-fired power by the end of this decade (Government of Canada, 2018). These commitments to shift financial support by way of subsidies and public financing should be acted on in tandem in order to enable a swift and streamlined transition.

While some progress has been made over the past decade in phasing out fossil fuel subsidies in Canada, there is a long way to go, considering that federal subsidies for which data is available totalled at least CAD 1.91 billion in 2020 (not including public finance- and tax-related subsidies

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for which there is no data) (Corkal, 2021). Combined provincial subsidies are even greater; for example, the main fossil fuel-producing provinces of Alberta, British Columbia, Saskatchewan, and Newfoundland and Labrador together subsidized at least CAD 2.5 billion in the 2020/2021 fiscal year (McKenzie et al., 2022), and Quebec provided an average of CAD 300 million annually in fuel tax relief from 2011 to 2016 (Gass et al., 2017).

A barrier to fully meeting the phase-out commitment is the lack of a shared definition internationally and within the Canadian government. The original G20 commitment describes inefficient fossil fuel subsidies as those that “encourage wasteful consumption, reduce our energy security, impede investment in clean energy sources and undermine efforts to deal with the threat of climate change” (G20, 2009). However, as noted in a recent international review, there are no universally endorsed definitions for the three main elements of the commitment (i.e., what constitutes a fossil fuel subsidy; what makes a subsidy inefficient; and what is considered wasteful consumption) (Organisation for Economic Co-operation and Development [OECD] & International Energy Agency [IEA], 2022). Thus far, some countries have considered all fossil fuel subsidies to be inefficient (e.g., Italy, Peru), while others exclude industry support measures (e.g., Germany) and tax exemptions or reductions in support of consumption (e.g., Mexico), citing reasons such as retaining industry competitiveness and avoiding carbon leakage to countries with less stringent regulations (OECD & IEA, 2022). The United Kingdom Climate Change Committee (2021), for its part, considers that no fossil fuel subsidies should be classed as “efficient” in the United Kingdom.

Canada’s peer review with Argentina, where each country reviews the other’s fossil fuel subsidies, is ongoing and far behind schedule. The matter of defining fossil fuel subsidies and inefficiency in the Canadian context is central to achieving a meaningful outcome in this process. To the former point, defining fossil fuel subsidies has been the subject of a wealth of investigation and discussion, and we reiterate our recommendation (International Institute for Sustainable Development, 2019) for Canada to adopt the World Trade Organization definition, which is widely used by inventory processes around the world (Gerasimchuk et al., 2017; OECD, 2012) as well as in the UN Environment Program et al.’s (2019) recent advice to states on measuring and reporting subsidies. This definition includes financial benefits provided to businesses or industries, including direct transfers, foregone revenue, transfer of risk, and provision of goods and services.

The matter of determining inefficiency in the Canadian context, on the other hand, has received less attention and is the focus of this brief. The need for a process to identify inefficient subsidies in the Canadian context was underscored in a report from the Office of the Auditor General, which found that Canada’s assessment of inefficient subsidies was incomplete and “would benefit from clearly defining what inefficient means” (Commissioner of the Environment and Sustainable Development, 2019). Given that Canada’s international and domestic commitments centre on this language, it is important to clarify what constitutes these subsidies to ensure that they are phased out with accountability and transparency.



We present four criteria to assess the efficiency of fossil fuel subsidies in Canada:

1. Alignment with climate commitments
2. Support for a low-carbon economy
3. Just transition consistency
4. Best way to achieve the overall policy goal.

Subsidies must meet all four of these criteria to be considered efficient; failing to meet a criterion would deem the subsidy inefficient. In the following sections, we briefly describe each of these assessment criteria to provide guidance, as Canada has committed to evaluating and eliminating these subsidies in the next year.

## Criterion 1: Alignment with climate commitments

**In the context of climate change, does this subsidy negatively or positively affect our global ability to reach net-zero and meet Canada's nationally determined contribution target?**

Canada has a target of reducing emissions to 40%–45% below 2005 levels by 2030 and reaching net-zero by 2050, with the aim of limiting warming to 1.5°C. However, this 2030 target falls well short of the 60% reduction below 2005 levels that Canada would need to adopt to do its fair share (Holz et al., 2019). The IEA has modelled a global Net Zero Emissions by 2050 Scenario (IEA, 2021), and others have found that this scenario requires a 3%–4% decline in oil and fossil gas production per year with no new oil or fossil gas fields developed (Greenpeace et al., 2022). With an eye to equity and under the principle of common but differentiated responsibility, recent research has found that to meet its responsibility as a high-emitting country, Canada needs to exceed its existing targets and ramp down oil and gas production by 74% by 2030 (Calverley & Anderson, 2022). However, despite efforts to date, the national emissions inventory shows Canada's emissions have only fallen by 1.1% over the past 15 years (prior to the pandemic), and emissions from the oil and gas sector continue to be the fastest growing across the Canadian economy (Al-Aini et al., 2022).

Any subsidies that support energy industries must be assessed for compatibility with Canada's climate commitments and the latest net-zero modelling. Canada should look to international net-zero models that are compatible with the Paris Agreement (Bois von Kursk & Muttitt, 2022), and the Canada Energy Regulator should move quickly to create 1.5°C-aligned domestic scenarios (McKenzie, 2021). Existing and proposed new measures should be examined to see whether they contribute to or undermine Canada's emissions reduction efforts in line with such scenarios and commitments. For instance, if a subsidy is supporting new or updated fossil fuel infrastructure that will enable the continued extraction and use of fossil fuels over decades, it will most likely adversely affect Canada's chances of meeting its climate target. It is also important to keep in mind that a subsidy that facilitates the export of fossil fuels has effects outside of Canada's borders during combustion (scope 3 emissions); such a subsidy is unlikely to be compatible with



the production phase-down necessary for global carbon neutrality. Subsidies in line with net-zero commitments should be directed toward proven technologies in clean energy and energy efficiency and should avoid investment in risky, uncompetitive, or unproven technologies like carbon capture, utilization, and storage that could lock us into our dependence on fossil fuels for decades to come.

Further, a consideration of the efficiency of subsidies must consider the economic and human impacts of climate change that the continued use of oil and gas exacerbates. Subsidies that support the expansion of fossil fuels and long-term reliance on them contribute to the social, environmental, and economic harms that will result from climate change. These long-term costs must be weighed against short-term benefits or efficiencies to determine the net effect. The latest IPCC report estimates the economic costs of climate change impacts in Canada to be around CAD 1.9 billion per year and rising, with the cost of combating these impacts also rising (for example, fire suppression in Canada now costs almost CAD 1 billion annually) (IPCC, 2022). One study finds that a business-as-usual emissions scenario would reduce Canada's economic output per capita by 13.3% below where it would otherwise be in 2100 (Kahn et al., 2019). Energy subsidies must be created with an eye to the long-term trajectory of the financial incentives or investments, any potential opportunity costs, and the contribution to emissions driving climate change.

## Criterion 2: Support for a low-carbon economy

### **Does the subsidy make it easier to transition to a low-carbon economy that is in line with a 1.5°C scenario?**

Financial incentives and disincentives are two of the most important ways to combat pollution and guide investment decisions. This is why Canada has introduced carbon pricing (Government of Canada, 2022). Fossil fuel subsidies work in opposition to carbon pricing by artificially lowering the production and consumption costs. This market distortion in favour of fossil fuels and to the detriment of renewables or energy efficiency is well documented (Moerenhout & Irschlinger, 2020) and slows the transition to a low-carbon economy. Government subsidies should not work against the government's efforts to provide clear economic predictability for the goal of transitioning.

Subsidies targeted to develop a low-carbon economy should respect the polluter-pays principle. This principle—in which producers of pollutants and wastes should bear the responsibility for their actions and pay the costs they impose on society—has been incorporated in keystone environmental protection legislation in Canada (Smith & Hauptman, 2020). The cost of investments for decarbonization in the fossil fuel sector should be borne directly by the companies themselves.

In addition to sending the wrong signal to investors, fossil fuel subsidies increase the risk of stranded assets in a context wherein global demand for fossil fuels will decline in the medium to long term. Current subsidies for the construction or maintenance of infrastructure must take into



account the payback period required for projects to be profitable, and the economic scenarios used to determine the financial risk of a potential project should account for climate-related risks and global momentum for climate action. Subsidies for projects that are likely to become stranded before the end of their payback period should therefore not be granted. This is especially relevant in Canada, which is among the countries with the largest potential losses from stranded fossil fuel assets, estimated at about USD 100 billion (Semieniuk et al., 2022). Investments that require decades of fossil fuel infrastructure use may expose the financial system to severe market disruption (Monasterolo, 2020).

### Criterion 3: Just transition consistency

#### Is the subsidy aligned with just transition principles?

Canada's work on fossil fuel subsidies needs to be linked to its forthcoming legislation and to its multiple international obligations on just transition. These include, but are not limited to, the Paris Agreement, the Silesia Declaration, and the COP 26 Just Transition statement, as well as the principles outlined in the International Labour Organization's (ILO) (2015) *Guidelines for a Just Transition Towards Sustainable Economies and Societies for All*.

Two of the ILO guiding principles that are particularly relevant to the fossil fuel subsidy context are:

Principle (d), which states that “Coherent policies across the economic, environmental, social, education/training and labour portfolios need to provide an enabling environment for enterprises, workers, investors and consumers to embrace and drive the transition towards environmentally sustainable and inclusive economies and societies” (ILO, 2015, p. 6).

And

Principle (e), which argues that “These coherent policies also need to provide a just transition framework for all to promote the creation of more decent jobs, including as appropriate: anticipating impacts on employment, adequate and sustainable social protection for job losses and displacement, skills development and social dialogue” (ILO, 2015, p. 6).

Subsidies that promote the growth of—and draw workers into—a sector that is bound to shrink between now and 2050 work against the transition toward environmentally sustainable and inclusive economies and societies. They also do not anticipate the impacts of the transition on employment or provide social protection and skills development. They are therefore not in line with ILO principles and Canada's obligations.

Obviously, the protection, safety, and well-being of workers are important, and to ensure a just transition, this must remain a long-term concern. A just transition requires advance notice to workers and communities and a transition plan to create other meaningful employment opportunities. Subsidies must avoid securing short-term jobs that will disappear in the medium





term. Instead, they should enhance the “enabling environment” that the ILO calls for to allow workers to drive the transition and create good-quality, lasting jobs.

Further, many current subsidies cite employment or job creation commitments, but these are most often not followed up on or tracked consistently. If the funds used to subsidize sectors headed for decline were redirected to create employment opportunities and growth in non-polluting energy sectors, electrification, retrofitting, and other low-carbon industries, which need to grow rapidly over the coming decades, they would be better able to provide stability for workers (see criterion 4). The job creation from such subsidies would need to be tracked and reported on for accountability.

## Criterion 4: Best way to achieve the overall policy goal

**Taking into account all costs and benefits, is this measure the best policy or program to achieve the stated environment, social, and/or economic aims?**

Many fossil fuel subsidies are created with environmental, social, or economic benefits in mind, such as lowering energy prices for people in need, reducing emissions from oil and gas production, or stimulating job creation. These potential benefits for Canadians should be central to government decision making and are particularly important in times of high and volatile energy prices, such as we have seen recently. However, it is important that these benefits, and the policies used to achieve them, be accurately assessed. Fossil fuel consumption subsidies are often found to be regressive, benefiting the wealthy disproportionately rather than supporting more vulnerable segments of the population (Granado et al., 2010). Given that these subsidies increase fossil fuel consumption and resulting impacts, the trade-off between emissions reductions and potential social benefits must be weighed.

The question, then, is whether a given subsidy is better at achieving its intended aims than alternative uses of the same money that would decrease emissions or other environmental impacts (or, exceptionally, result in less of an increase in emissions). This question gets to the heart of the definition of “efficiency.” Inherent in this is the need to disclose what the objectives of the subsidy are and the need to do a comparative analysis of the available options for achieving those objectives. This should consider the costs and benefits over the whole life cycle of the measure. If the aim is to create long-lasting jobs, could the money have been better spent in other sectors with faster growth and a brighter economic future? If the aim is to support an economically fragile segment of the population, are there more direct ways to support those communities through, for instance, direct transfers to individuals or businesses? If the aim is to reduce emissions from oil and gas production, could regulatory and polluter-pays programs achieve the same outcomes at lower expense to the taxpayer? And if the aim is to support economic development and opportunity through public financing, is this being directed toward economically and environmentally sustainable industries in line with a 1.5°C scenario?

In some very specific cases, a fossil fuel subsidy may be the most effective way to achieve the stated goal in the short term. For instance, some subsidies for remote and northern communities



that are reliant on diesel serve an important function in supporting energy access and are relatively small, totalling just CAD 2.37 million in 2020 (Environmental Defence, 2021). However, despite their positive goals, these subsidies can still act as a barrier to the uptake of alternatives and facilitate negative impacts related to fossil fuel use, such as local pollution. In these instances, a time frame must be established to phase out the subsidy in coordination with subsidies and enabling policies focused on creating access to more sustainable alternatives to ensure that communities are able to transition to more secure and reliable energy supplies as fossil fuels are phased out.

## Conclusion

The criteria presented here provide a critical assessment framework for determining the efficiency of fossil fuel subsidies. These criteria, which are in line with Canada's existing commitments on climate change, make it clear that there is very limited room for efficient fossil fuel subsidies within these commitments, except in very specific, time-limited circumstances.

We recommend that the Canadian government adopt and apply these criteria to assess fossil fuel subsidies in the context of their domestic and international commitments on climate change and climate finance. Specifically, we recommend that:

- These criteria be applied within Canada's ongoing self- and peer review of fossil fuel subsidies with Argentina, including tax and non-tax measures, which should include examining subsidy elements of public financing.
- These criteria be applied in fulfilling Canada's commitment to phase out inefficient fossil fuel subsidies by 2023. For transparency, government should make its analysis publicly available and should assess all subsidies (using the World Trade Organization definition) against these criteria.
- These same criteria be used to evaluate public financing of fossil fuels in relation to Canada's commitments to phase out public financing domestically and internationally, as written in the federal ministers' mandate letters and the Glasgow Agreement on international public finance. The results of such an evaluation should be made public.
- The federal government ensures that no new subsidies or public finance for fossil fuels are introduced. All proposed policy measures with the potential to financially benefit fossil fuel consumption or production should be assessed against these criteria in order to prevent new subsidies from being created.
- The federal government encourage provinces to adopt these criteria to assess provincial fossil fuel subsidies and public finance and to phase out all measures considered inefficient.

Clearly defining and evaluating the efficiency of subsidies is critical to ensuring that Canada's commitments on subsidies and public finance this year and next are met with transparency, timeliness, and accountability, both domestically and internationally.



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