CANADA: ALL OUR EGGS IN THE ENERGY BASKET?

PRESENTATION

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Canada West
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GOOD AFTERNOON, EVERYONE. Thank you, Stephen, for your kind welcome, and to all of you for having me join you today. As head of the Canada West Foundation, my job is to ensure the Foundation is advancing policies that will shape western Canada's long-term prosperity. And so, I particularly appreciate opportunities to talk with westerners who are active citizens, like you.

I cannot even begin to tell you what a privilege it is to speak to Rotarians. What you have achieved together is astonishing from the international fight against polio to the work you do every day here in Calgary. My hat goes off to you.

My comments today are going to be about the oil sector and how we talk about it as a country.

In 2006, Stephen Harper was a rookie prime minister. A few months into the job, it was time for his first speech to a business community. In it, he set out a visionary – some would say lofty – goal for the country. He said his government intended to turn Canada into an "energy superpower." Since then, Harper has used this term repeatedly.

Fast forward nine years to today. The price of oil is low, under fifty dollars a barrel. The Keystone XL and Northern Gateway pipelines – proposed seven and five years ago – have faced unexpected and extraordinary opposition. The prime minister's energy policy is under a lot of scrutiny.

I was recently asked whether the federal government made a terrible mistake by placing all of Canada's eggs into one basket – namely, the oil sector. It struck me as the wrong question to be asking. What I'd like to examine with you today is the extent to which our eggs are actually in the oil basket.

There are four arguments most commonly used to make the case that Canada is over-reliant on oil. I'm sure everyone in this room has heard these, or some variance of them. The first is that fossil fuels are heavily subsidized by the public purse. The second is that our diplomatic efforts on energy files occur at the expense of other issues. Third, that Canada has a case of Dutch Disease – a situation where it is claimed that a strong resource revenue hurts the rest of the economy. And fourth, that focusing on oil production prevents economic diversification.

Let's start with the first argument. How much is oil production subsidized with our tax dollars?

In 2014, subsidies[1] from the federal and provincial governments combined amounted to about $211 million.[2] It seems hard to believe that the sector that has been driving Canada's economic growth is receiving any amount of government funds. The federal subsidies, at least, are decreasing. This year, the two largest expenditure programs[3] considered to be subsidies are no longer available on new assets. So, in 2016, subsidies to oil and gas companies from all levels of government will total about $71 million. To give you a sense of scale, that is three-and-a-half time less than annual federal expenditures on the Automotive Innovation Fund – money the government contributes to auto firms that are researching new vehicle technologies.[4]

Seventy-one million dollars sounds like a lot – I know I could certainly think of many things I could do with that amount of money! But in comparison, oil and gas producers pay about $18 billion in taxes and royalties to both levels of government each year. Yes, that is "billion" with a "B"! Our governments receive an $18 billion revenue stream every year that can be used to pay for schools, hospitals, roads, education and

[1] Financial support given to promote a certain activity.
[2] This figure includes subsidies to oil, natural gas, and coal.
[3] Accelerated Capital Cost Allowance for oil sands projects and the Atlantic Investment Tax Credit for property used for oil, gas and mining activities.
[4] $500 mil / 2 years http://hkstrategies.ca/insight/2014-federal-budget-instant-analysis/

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health care. Combined, both levels of governments are investing about .03 per cent of the revenue they receive back to the oil and gas sector.

From a financial perspective, we know this is not a unique investment. It also doesn't appear to be taking away from federal investments into cleaner parts of our energy sector. In his 2006 "energy superpower" speech I mentioned earlier, Harper talked about investments in renewable energy being part of his strategy. Under Harper, the federal government has spent billions on a whole suite of subsidies branded as various "ecoENERGY" programs. There was $1 billion for biofuels, and $1.4 billion for renewable power production. Another one billion for a Clean Energy Fund to be spent on renewable energy projects and carbon capture and storage. It is difficult to imagine that all this energy diversification would be financially possible without the extraordinary royalties being generated by the oil industry.

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The second argument you may have heard is that the federal government's diplomatic efforts are too concentrated on energy-related files, and other issues are suffering because of it.

Without a doubt, the federal government has invested significant time and effort on some key international energy issues. The prime minister and multiple federal ministers have been vocal in calling upon President Obama to approve the U.S. portion of the Keystone XL pipeline. Canada has consistently opposed Europe's Fuel Quality Directive proposal which would essentially make European imports of Canadian oil more expensive than heavy oil imports from other countries.

The federal government has not been the only one doing heavy lifting on these files. Affected provinces have spent just as much – if not more – time and money. Saskatchewan's Premier Brad Wall may as well be Canada's spokesperson on Keystone XL. He got 10 governors of states on the XL route to co-sign a letter with him urging President Obama to approve the pipeline. Saskatchewan has spent over $3 million lobbying decision-makers in the United States. Likewise, Alberta's premiers – I've nearly lost count of how many there have been since KXL was proposed! – have also spent a considerable about of time in Washington. You might remember the Alberta's government's ad campaign in the U.S. media promoting KXL, including a $30,000 ad in the New York Times.

Energy is a live piece of Harper's foreign policy efforts and his economic strategy – but no more so than other issues. Defence of Israel has ranked high on the diplomatic agenda since the Conservatives took office. More recently, Ukraine has also been a major focus as have international efforts to stem ISIS.

If I had to describe Harper's economic policy in two words, I would use "free" and "trade." And then I would ask for a third word, so I could add "agreements." Harper has more than doubled the number of Canada's free trade agreements in an attempt to diversify markets for all sorts of Canadian products.[5] Eleven more agreements are under negotiation. Canada invested $1.4 billion in infrastructure projects to improve supply chains to the West Coast as part of its Asia Pacific Gateway and Corridor Initiative. Gaining access to Asian Pacific markets is not just for the benefit of the oil sector – a sector that does not even have the infrastructure in place to ship any significant amount of product west. Canada, and – luckily for us – western Canada in particular, have what Asia is craving, from agricultural and forestry products to industrial goods and logistics expertise.

[5] Four FTAs when Harper became PM, 10 in place today.

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To be sure, the federal government has invested time on international files related to the competitiveness of the Canadian oil patch, with mixed results. At the same time, it is difficult to imagine a sitting government of any stripe that would not take similar positions for an industry that is so important to the national economy. The effort has been both federal and provincial and justified, I would suggest.

The third argument, one that seems especially prevalent in the media, is that Canada has caught a case of Dutch Disease. Many commentators and at least one federal political party leader have blamed central Canada's manufacturing downturn on this ailment.

It is basically hogwash.

From 2002 to 2011, the dollar rose from 63.7 cents US to US$1.01 a 59 per cent increase. During that same period, manufacturing employment in both the US and Canada dropped identically – by 23 per cent. And of course we know that the US is NOT a petroleum exporter. So why the same outcome?

We all know the primary reasons:

- low-cost competition from China, Vietnam, Indonesia and other countries AND
- lower global demand for stuff caused by an aging population in the developed world.

Another reason that gets less attention is the over-exposure of Canada's manufacturing sector to the US economy. The US is a weak long-term prospect because its government is buried in debt and its population is aging. The challenge for Canadian manufacturing to find new markets is just as important as for our energy sector.

Further, as people get wealthier, there is a natural shift from goods to services. After you've bought your lawn mower and your couch, you are more likely to travel or eat in a restaurant.

My point is that Canada's manufacturing sector faces deep challenges for a variety of reasons.

The question is whether a booming resources sector is a help or a hindrance in facing those challenges.

A recent excellent study published by our friends at the Institute for Research on Public Policy examined what parts of the manufacturing sector in Canada have been affected by high resource prices.[6]

They analyzed 80 industries.

Real decline due to currency appreciation was found in textiles, apparel and leather products. This area accounts for less than 2 per cent of Canadian manufacturing output and the reasons for the decline are instructive. These industries are labour intensive, their product lines are homogenous compared with their competitors and they face higher penetration of competitive products from countries with low labour costs. In other words, these industries were already in trouble, are not innovation centres and did not have real prospects to be high wage or high quality employers now or into the future.

The transportation sector and the food sector showed some negative output effect although in the food sector, output was still higher due to other factors.

[6] Shakeri, Gray and Leonard, "Dutch Disease or Failure to Compete?" *IRPP Study*, No. 30, May 2012.

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The automotive sector essentially showed no "Dutch Disease" related effects, not surprising given that they wouldn't experience as much wage competition from the resources sector as they are already pay good wages and because of the extent to which these sectors rise and fall with the fortunes of the North American economy rather than currency dynamics.

For aerospace and shipbuilding there was a small positive effect from energy activity. The chemicals industry, not surprisingly, experienced a strong positive effect.

I could go on, but the general trend is that industries that have strong differentiated products and invest in R&D, pay good wages and make investments to increase productivity to support those wages, are not heavily exposed to energy revenue effects and indeed can benefit from energy sector demand. So much for Dutch Disease.

The final argument we hear time and again is that our economy is not diversified because we are so focused on oil production. And here I have to concede something. It is true. It is very difficult for other industries to develop when they are competing for talent with the oil industry. Why? Because citizens choose to work in that industry because it pays well or because they find it more satisfying for other reasons. And, of course, the industry also pays for satisfying well paying jobs in the public sector as well – creating yet more competition for talent.

The problem is that the oil sector is not sustainable beyond two or three generations. For that reason, it is vital:

→ first, to stop treating oil revenues as an operating stream to drive up public sector costs unsustainably and further diminish the opportunity for the market to create good employment in other ways; and,

→ second, to support strategic diversification in other high margin business areas primarily through maintaining competitive taxes, good infrastructure and supporting a skilled labour force.

What government should avoid is trying to buy other industries through subsidies. When government pours money into firms or sectors it selects, it is picking winners and losers. There is a big gamble with this. Firms that develop in an artificially sheltered environment created by government often can't survive in an open market. Government subsidies must either continue forever, or the firms fail when the support is no longer available. Neither option provides the taxpayer with much value. To be successful, a diversification strategy requires an exit plan right from the beginning. The government must plan carefully and exercise discipline in executing the plan. Unfortunately, we know these steps are not always easy for a government to take.

In Alberta, "economic diversification" often refers to increasing the amount of bitumen we upgrade domestically. However, this "value-added" industry is not really diversification because it is still completely reliant on bitumen and the price of oil. In Alberta's traditionally tight labour market, a larger value added sector would directly compete with the extraction sector for the same employees, further restricting the labour market for both sectors. Since the 2008 recession, five of the seven upgrader projects planned by the private sector were cancelled or postponed, because the economics no longer made sense. Pouring tax dollars into a business the private sector has deemed unprofitable does not provide value for taxpayers. It does the opposite.

So, the criticism that the oil sector impairs diversification has some merit but it would be foolish to ignore the bird in hand while chasing birds in the bush, especially when the bird in hand is goose laying golden eggs!

In general, measures to make Canada an attractive place for business, such as the choice to lower the corporate income tax rate from 21 to 15 per cent are the right approach. And this avoids the risks of government picking winners.

Canada's economy runs on four cylinders: the West, Ontario, Quebec and the Atlantic provinces. It is a problem that for the last decade, only the western cylinder has been firing.

Some of Canada's eggs are in the energy basket, but not all of them. For the most part, the federal government is leaving the eggs alone so Canadians can pick which basket to put them in.

My biggest concern with the question about whether the prime minister has been too reliant on the energy sector is that it really is a political attack based on an outdated "west versus east" attitude. It raises a broader question of how we can move forward as a country without the either/or attitude of "when Alberta prospers, Ontario suffers" and vice versa.

Canada's economy runs on four cylinders: the West, Ontario, Quebec and the Atlantic provinces. It is a problem that for the last decade, only the western cylinder has been firing. Ontario and Quebec's manufacturing sector is something we should care about in western Canada. And they should also care about the success of our resource sector.

We should reject any calls that say the right kind of country is one where Ontario is successful, and the West is just there to play a supporting role. We should ask the question: How do we work together to get Canada firing on all four cylinders? If we start having this discussion, then we will be talking about the right thing.

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