

GUIDANCE

FOR USING CARBON POLLUTION PRICING PROCEEDS

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Environment and
Climate Change Canada

Environnement et
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Canada

GUIDANCE

FOR USING CARBON POLLUTION PRICING PROCEEDS TO SUPPORT CANADIANS AND DRIVE CLIMATE AMBITION

A price on carbon pollution is an essential part of Canada's plan to fight climate change and grow the economy. It is one of the most efficient ways to reduce greenhouse gas emissions and stimulate investments in clean innovation. It creates incentives for individuals, households, and businesses to choose cleaner options.

Carbon pollution pricing, if designed thoughtfully, can drive down greenhouse gas emissions while keeping life affordable for families. One way to help families come out ahead is to use some or all of the proceeds to support consumers.

This Guide outlines approaches for designing government programs that use carbon pricing revenue in a way that maintains the carbon price signal required to reduce greenhouse gas (GHG) emissions while ensuring affordability for households, particularly Indigenous, low-income and other vulnerable populations. It also outlines approaches for supporting affected sectors, including small and medium-sized enterprises and emissions-intensive, trade-exposed industries, to prevent carbon leakage and support decarbonization and the transition to a net-zero economy.

As part of Canada's climate plan, provinces and territories have the flexibility to maintain or implement a carbon pollution pricing system that works for their circumstances, provided it meets federal benchmark stringency requirements. As has been the case for the past few years, post-2023, any provincial or territorial government that requests the federal system be utilized in their respective jurisdiction will receive pricing proceeds directly, with a condition that those governments do not take actions to weaken, negate or reduce the price signal. As such, provinces and territories have a key role in using proceeds in a way that address these concerns and is appropriate to their unique circumstances.

This document outlines the federal approach and provides guidance as to how proceeds can be used to support Canadians and Canadian business in ways that do not negatively impact the overall effectiveness of pricing.

THE FEDERAL APPROACH TO CARBON PRICING AND USING PROCEEDS

To ensure carbon pollution pricing applies in a consistent manner throughout Canada, the federal backstop pricing system will be in place – in whole or in part – in any province or territory that requests it or that does not have a pricing system that aligns with the federal benchmark requirements.

FEDERAL APPROACH TO CARBON PRICING PROCEEDS RECYCLING

The Government of Canada does not keep any direct proceeds from pollution pricing. All direct proceeds from the federal system are returned to the province or territory of origin in the following way:

- For those jurisdictions that have voluntarily adopted the federal system, direct proceeds from the federal fuel charge and Output-based Pricing System are returned to the governments of those jurisdictions.
- In other jurisdictions where the federal system applies, the Government returns the vast majority of direct fuel charge proceeds to households through Climate Action Incentive payments.
- The remaining fuel charge proceeds are used to support key sectors and populations including trade-exposed small businesses, farmers and Indigenous groups.
- Federal Output-based Pricing System proceeds for large industrial emitters will be returned via a merit-based program focused on reducing emissions from industrial facilities and to support grid-greening projects in the electricity sector.

The Government of Canada has made affordability a priority, in particular for low income and vulnerable households. Proceeds can be used very successfully to address affordability concerns. The current approach used for the federal pricing system results in the majority of households being better off.

Recognizing that people who live in small, rural, and remote communities have reduced access to cleaner transportation options, policy-makers may consider providing additional support for those communities. The federal Climate Action Incentive provides a 10 % top up for eligible individuals and families who live outside a census metropolitan area, as defined by Statistics Canada.

In addition to the general Climate Action Incentive rebate, the Government of Canada will also return 1 % of proceeds to Indigenous communities through a co-developed approach. Small and medium sized enterprises (SMEs) are a major employer across Canada providing essential goods and services for Canadians. Some of these businesses export their goods and compete in international markets, which may not have a price on pollution. In order to help support these businesses to become more competitive and avoid carbon leakage, a dedicated portion of carbon pricing proceeds (in jurisdictions using the backstop) will be delivered through a program to trade exposed SMEs.

The federal government has published key elements of its updated benchmark for carbon pricing systems in Canada for the 2023-2030 period, and will post a final benchmark before the end of July. Changes in the benchmark aim to improve consistency and ensure that carbon pricing systems continue to drive low-cost emission reductions required to meet Canada's climate commitments and build a cleaner, more prosperous economy.

The updated benchmark will preclude actions that directly reduce or negate the marginal carbon price signal but otherwise will not impose specific requirements for how provinces and territories use the proceeds from their systems.

Carbon pricing proceeds are one way to address fairness and affordability. Federal, provincial and territorial governments are also making a range of investments to lower emissions and support households, including the Canada Greener Homes Grant, incentives for purchase of zero emissions vehicles, and significant investments in transit and active transportation.¹

USING PROCEEDS WHILE MAINTAINING THE PRICE SIGNAL

The carbon price signal drives emission reductions in carbon pricing systems. By putting a price on pollution, households and businesses have an incentive to choose lower or zero emitting alternatives. However, if the proceeds from carbon pricing are not returned carefully, they can undermine or eliminate the carbon price signal, leading to fewer emission reductions and making it harder and more costly to achieve Canada's greenhouse gas emissions goals and economic ambitions.

While this Guide focuses on the carbon pricing proceeds, the same considerations for maintaining the carbon price signal extend to other government spending and programs.

Jurisdictions use proceeds from pricing carbon pollution in different ways to support a range of goals and priorities, including supporting further emissions reductions and the transition to a net-zero economy, reducing income taxes, or debt reduction. These approaches to using carbon pricing proceeds can all be designed in a way that maintains the price signal.²

However, since carbon pricing policies on their own have the potential to disproportionately impact low-income and other vulnerable populations, jurisdictions should also consider how proceeds can be used to mitigate those impacts to ensure the overall policy is fair.

Based on its expert assessment of carbon pollution pricing systems in Canada, the Canadian Institute for Climate Choices recommended, "any rebates that are directly tied to fuel purchases or the level of emissions should be replaced with other approaches to recycling carbon pricing proceeds such as direct rebates, income tax reductions, or abatement technology subsidies."³



1 Canada's Strengthened Climate plans outlines multiple federal measures - <https://www.canada.ca/en/services/environment/weather/climate-exchange/climate-plan/climate-plan-overview/healthy-environment-healthy-economy.html>

2 The Ecofiscal Commission paper "Choose Wisely: Options and Trade-offs in Recycling Carbon Pricing Revenues" is a useful resource to guide consideration of approaches to the return of carbon pricing proceeds while maintaining the marginal price signal. <https://ecofiscal.ca/reports/choose-wisely-options-trade-offs-recycling-carbon-pricing-revenues/>

3 The CICC Report is available at: <https://publications.gc.ca/site/eng/9.900084/publication.html>

One type of action that is to be avoided is the provision of instant rebates on fossil energy purchases, for example by reducing specific fuel taxes in order to offset increased carbon prices. This kind of rebate counteracts the incentive to reduce GHG emissions. By contrast, a lump sum payment that is completely separate from an individual's energy purchases maintains the carbon price signal. Since this latter kind of payment does not adjust based on actual energy use or emissions, the individual has an incentive to reduce energy use and still collect the full payment. This approach is implemented by the federal government through the Climate Action Incentive payment.

Carbon pricing can be effective with proceeds used in a variety of ways, as long as the return mechanism does not negate or lower the price incentive. The amount returned should not be linked to a household's or business' level of GHG emissions, fossil energy use, or carbon price payments. Nor should proceeds be used to reduce other charges, fees or taxes on emissions or energy use in a way that offsets the carbon price.

APPROACHES FOR USING CARBON PRICING PROCEEDS

Mechanisms for using carbon pricing proceeds include: lump sum payments to individuals, households, businesses, or large emitters; reductions of taxes or charges unrelated to energy use or emissions; and programming to advance climate action or support vulnerable populations. A government could also use carbon pricing proceeds for general revenue.

Policy makers may have more than one goal for the use of carbon proceeds and may combine approaches to contribute towards these different goals. For example, a portion of proceeds could be allocated to addressing impacts on low-income households with the balance allocated to programming or general revenues.

Canadian experts have assessed a wide range of options for using carbon pricing proceeds, including assessments of their affordability and implications for economic growth. Provinces and Territories should consider this literature⁴ when designing their approach to using carbon pricing proceeds.

Proceeds used for emission reduction programs should ideally target reductions beyond those already incented by carbon pricing. Programming can also address market failures that impede pricing and can be used to support the deployment of supportive infrastructure that receives less of a direct incentive from carbon pricing. This could include, for example, investments to make low-carbon fuels and technologies more widely accessible. These investments should also consider if the assets being funded are aligned with a net-zero future. This will avoid future stranded assets. Other sources of emissions reductions that may not be incented by carbon pricing include new or emerging technologies which have uncertain performance when deployed at a large scale. Additional support for these new technologies may reduce the risk associated with their adoption.

Transparency on the collection, use, and results achieved by any programming funded by carbon pricing pollution proceeds is also important for good governance and can build public support for the policy.

4 [Winter_Dolter_Fellows_working_version_June2021.pdf](#) (smartprosperity.ca) and <https://ecofiscal.ca/reports/choose-wisely-operations-trade-offs-recycling-carbon-pricing-revenues/> are two recent examples.

ISSUES TO CONSIDER, POTENTIAL APPROACHES AND APPROACHES TO AVOID

Households

Issues to Consider

- Addressing the potential disproportionate impacts of carbon pricing on Indigenous communities, low-income individuals and households.
- Addressing limited access to alternatives (e.g., transportation outside of urban centers) in the short term.
- Future proofing for net-zero: ensuring the right infrastructure is available to support behavioral changes and avoid investment in future stranded assets.

Potential Approaches

- Lump sum payments such as the Climate Action Incentive payments.
- Reducing income tax rates.
- Allocating a portion of carbon pricing proceeds to Indigenous communities.
- Consider timing and frequency of payments, e.g., return before costs are incurred or more than once a year as price increases, to address potential household budget constraints.

Approaches to Avoid

- Payments that vary according to the amount of carbon price paid or fossil energy used.
 - Offsetting the carbon price through reductions in other charges, taxes or fees that change with the amount of carbon price paid.
 - Carbon price “discounts” for specific actions, for example, a preferential rate for households that install efficient space heating equipment.
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Small and Medium Enterprises

Issues to Consider

- Support for transition to low carbon future, supportive infrastructure.
- Support for trade-exposed small industries that cannot fully pass on costs to customers but are not eligible for large industry relief.

Potential Approaches

- Consider allowing small emission intensive trade exposed facilities to opt-in to approaches for large industry that mitigate risks of carbon leakage.
- Consider targeted payments based on firm size for specific trade exposed sectors. Green retrofit programs designed to address potential barriers to adopting technology that would otherwise be incented by the carbon price.

Approaches to Avoid

- Payments that vary according to the carbon price paid or fossil energy used.
- Carbon price “discounts” for specific actions.

Emissions Intensive Trade Exposed Large Industry

Issues to Consider

- Risk that carbon pricing proceeds return design could influence choice of compliance approach, for example, rebates tied to facilities’ carbon price payments would favour paying the emissions charge instead of purchasing credits from other facilities, which could reduce the financial benefits to other firms of reducing their emissions.

Potential Approaches

- Open competition merit-based funding to support further incremental emission reductions.
- Implement an approach that returns carbon-pricing proceeds based on a measure of output or emissions intensity improvements relative to a stringent benchmark.
- In carbon pricing systems with emissions trading, take into account the impact of any emission reduction investments on the potential supply and demand balance in the market and make corresponding adjustments to the pricing system to ensure the market continues to function effectively.
- Ensure any investments support the transition to a net-zero economy to avoid stranded assets.

Approaches to Avoid

- Refunds based on carbon price paid, GHG emissions, or fossil energy used.
- Offsetting reductions in other charges, taxes or fees that change with the amount of carbon price paid.
- Carbon price “discounts” for undertaking specific actions.
- Funding actions that would be already be incented by carbon pricing.