Spring 2019

Reports of the Commissioner of the Environment and Sustainable Development to the Parliament of Canada

Independent Auditor's Report

REPORT 3

Tax Subsidies for Fossil Fuels—Department of Finance Canada

Office of the Auditor General of Canada

Bureau du vérificateur général du Canada

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This report presents the results of a performance audit conducted by the Office of the Auditor General of Canada under the authority of the *Auditor General Act*.

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- gather the evidence necessary to assess performance against the criteria,
- report both positive and negative findings,
- conclude against the established audit objectives, and
- make recommendations for improvement when there are significant differences between criteria and assessed performance.

Performance audits contribute to a public service that is ethical and effective and a government that is accountable to Parliament and Canadians.

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Cat. No. FA1-26/2019-1-3E-PDF
ISBN 978-0-660-29837-5
ISSN 2561-1798 (Print)
ISSN 2561-1801 (Online)

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Introduction

Background

Fossil fuel subsidies

3.1 Fossil fuels, such as coal, natural gas, and oil, are a non-renewable source of energy. They have an impact on Canada's economy; for example, in 2017, their extraction contributed to approximately 9% of Canada's gross domestic product (GDP). They also have an impact on the environment, because when burned, they produce carbon dioxide, a significant greenhouse gas that contributes to climate change.

3.2 The two largest contributors to Canada's total greenhouse gas emissions in 2016 were the oil and gas sector and the transportation sector. They constituted about half of Canada's total greenhouse gas emissions.

3.3 These sectors are also among those that receive government subsidies. Subsidies are a tool that governments can use to promote economic activity or to pursue environmental or social goals, such as reducing pollution or helping vulnerable communities.

3.4 Subsidies can include

- **tax expenditures**,
- grants and contributions,
- government loans or loan guarantees at favourable rates,
- resources sold by government at below-market rates,
- research and development funding, and
- government intervention in markets to lower prices.

3.5 Subsidies, both in general and for the energy sector, are defined differently in international agreements and by international organizations of which Canada is a member (Exhibit 3.1). The definitions do, however, contain a common concept that a subsidy provides an advantage.

Tax expenditure—A type of **tax measure**, such as a preferential tax rate, exemption, deduction, deferral, or credit, with which the government aims to achieve public policy objectives through the tax system.

Tax measures—Provisions of the *Income Tax Act* applicable to all or certain taxpayers.

Exhibit 3.1 How various international organizations define "subsidy"

Definition	Source
A subsidy has "three basic elements: (i) a financial contribution (ii) by a government or any public body within the territory of a Member (iii) which confers a benefit. All three of these elements must be satisfied in order for a subsidy to exist."	World Trade Organization
An energy subsidy is "any government action that lowers the cost of energy production, raises the revenues of energy producers or lowers the price paid by energy consumers."	International Energy Agency
Consumer subsidies exist "when energy consumers pay prices that are below the costs incurred to supply them with this energy." Producer subsidies exist "when producers receive either direct or indirect support that increases their profitability above what it otherwise would be."	International Monetary Fund
A subsidy for fossil fuels is a deliberate policy action by the government that specifically targets fossil fuels, or electricity or heat generated from fossil fuels, and has one or more of the following effects: A. Reducing the net cost of energy purchased B. Reducing the cost of production or delivery of fuels, electricity, or heat C. Increasing revenues retained by resource owners, or suppliers of fuel, electricity, or heat The definition excludes policy actions that achieve these effects through promotion of efficiency improvement along the supply chain, greater competition in the market, or other improvements in market conditions.	World Bank

G20 commitment to phase out inefficient fossil fuel subsidies

3.6 The governments of Canada and other countries have made commitments to phase out and **rationalize** fossil fuel subsidies that they consider to be "inefficient":

- In September 2009, at the **Group of 20 (G20)** leaders' summit, leaders from the world's major economies committed to "phase out and rationalize over the medium term inefficient fossil fuel subsidies

Rationalization—The elimination of the subsidy element of a measure, such as reducing a tax deduction rate to a level that does not provide an advantage to particular types of expenses. For example, in the 2011 federal budget, it was announced that expenses incurred to bring new oil sands and oil shale mines into production, previously treated as Canadian exploration expenses (deductible at 100% in the year incurred), would be treated as Canadian development expenses (deductible at 30% annually).

Group of 20 (G20)—Twenty partners with advanced or emerging economies whose leaders meet every year to discuss the global economy and promote economic cooperation. The G20 members are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, the Republic of Korea, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States of America, and the European Union.

while providing targeted support for the poorest." The G20 leaders stated that fossil fuel subsidies that are inefficient "encourage wasteful consumption, reduce our energy security, impede investment in clean energy sources and undermine efforts to deal with the threat of climate change."

- In November 2015, the Prime Minister instructed the Minister of Finance to "work with the Minister of Environment and Climate Change to fulfill our G20 commitment and phase out subsidies for the fossil fuel industry over the medium-term."
- At the June 2016 North American Leaders' Summit, Canada, the United States, and Mexico committed to phasing out inefficient fossil fuel subsidies by 2025.

3.7 The leaders' statement of the 2009 G20 summit and subsequent statements did not define the term "inefficient fossil fuel subsidy."

United Nations' sustainable development goals

3.8 In September 2015, Canada committed to achieving the United Nations' 2030 Agenda for Sustainable Development. This audit supports the goal of responsible consumption and production (Goal 12 of the **United Nations' sustainable development goals**), which sets a target to "rationalize inefficient fossil-fuel subsidies that encourage wasteful consumption by removing market distortions, in accordance with national circumstances . . . to reflect their environmental impacts."

Department of Finance Canada

3.9 The Department of Finance Canada is responsible for providing analysis and advice on identifying which tax measures are subsidies that support or encourage the production or consumption of fossil fuels. The Department is responsible for providing advice to the Minister of Finance on whether these tax subsidies are inefficient, and for supporting the Minister on meeting Canada's G20 commitment to phase out and rationalize inefficient fossil fuel subsidies. The Minister ultimately makes the decisions.

United Nations' sustainable development goals—A list of 17 aspirational goals for achieving social, economic, and environmental **sustainable development** worldwide, as part of the United Nations' 2030 Agenda for Sustainable Development.

Sustainable development—Development that meets the needs of the present without compromising the ability of future generations to meet their own needs. It includes a long-term perspective and the integration of economic, social, and environmental sustainability to ensure future needs are met.

Focus of the audit

3.10 This audit focused on whether the Department of Finance Canada provided advice to support decision making on inefficient tax subsidies for fossil fuels that was based on analysis of all relevant and reliable information.

3.11 This audit is important because inefficient fossil fuel subsidies encourage wasteful consumption, undermine efforts to address climate change, and discourage investment in clean energy sources. Without providing decision makers with advice based on complete assessments, the Department of Finance Canada cannot ensure that it is providing the support needed by the Minister for Canada to meet its G20 commitment by 2025.

3.12 The audit follows up on the 2017 Spring Reports of the Auditor General of Canada, Report 7—Fossil Fuel Subsidies. In that report, we informed Parliament that we could not conclude on the work of the Department of Finance Canada because the Department denied our access to documents that supported analysis for decision making.

3.13 This audit was conducted in part to complete the work that we were not able to complete in 2017. In May 2018, the **Governor in Council** issued an order-in-council that clarified the Office of the Auditor General of Canada's right of access to information from federal organizations. In this report, the Department of Finance Canada provided us with access to the documents that supported analysis for decision making.

3.14 We also separately examined non-tax subsidies for fossil fuels. See the 2019 Spring Reports of the Commissioner of the Environment and Sustainable Development, Report 4—Non-Tax Subsidies for Fossil Fuels—Environment and Climate Change Canada.

3.15 More details about the audit objective, scope, approach, and criteria are in **About the Audit** at the end of this report (see pages 10–12).

Findings, Recommendation, and Response

Overall message ➔

3.16 Overall, we found that the Department of Finance Canada's assessments to identify inefficient tax subsidies for fossil fuels were incomplete, and that advice it provided to the Minister was not based on all relevant and reliable information.

Governor in Council—The Governor General, acting on the advice of the Privy Council, as the formal executive body that gives legal effect to those decisions of Cabinet that are to have the force of law.

3.17 The Department of Finance Canada conducted an overall assessment of tax expenditures—which reduce taxes payable by certain taxpayers and the amount of revenue that the government would collect—and identified those that provided a specific advantage to the fossil fuel sector as subsidies. At the end of June 2018, the Department had also begun assessing 2 of the 12 benchmark tax measures—general tax measures in the tax system—specific to the fossil fuel sector to identify those that could potentially be fossil fuel subsidies.

3.18 The Department of Finance Canada did not clearly define how a tax subsidy for fossil fuels would be inefficient. The Department's assessments focused almost exclusively on fiscal and economic considerations and did not consider the integration of economic, social, and environmental sustainability in subsidizing the fossil fuel sector over the long term.

Identification of inefficient tax subsidies

The Department of Finance Canada's assessment of inefficient tax subsidies for fossil fuels did not consider all relevant evidence

What we found

3.19 We found that the Department of Finance Canada completed a review of tax expenditures and further assessed for inefficiency those that it identified as tax subsidies. However, the Department did not clearly define what an inefficient tax subsidy for fossil fuels was. In addition, the Department performed incomplete assessments, which focused almost exclusively on fiscal and economic considerations. The assessments did not consider the economic, social, or environmental sustainability of subsidizing the fossil fuel sector for the tax subsidies the Department assessed during our audit period. We also found that at the end of June 2018, the Department began assessing 2 of the 12 **benchmark tax measures** specific to the fossil fuel sector to identify those that could be potential subsidies.

3.20 Our analysis supporting this finding presents what we examined and discusses the following topics:

- Definition of "inefficient"
- Assessments of tax subsidies
- Identification of benchmark tax measures
- Advice provided to the Minister

Benchmark tax measures—The most fundamental aspects of the tax system. An example is the basic personal amount that all individuals are entitled to deduct from their federal taxes.

Why this finding matters

3.21 This finding matters because the government needs to consider the integration of economic, social, and environmental sustainability to properly inform federal decisions on tax subsidies for fossil fuels. The Canadian benchmark tax system may contain tax measures that support the consumption or production of fossil fuels that could be considered potential subsidies.

Context

3.22 In our 2017 audit report, we found that the Department of Finance Canada had not defined what the G20 commitment meant in the context of Canada's circumstances. We recommended that the Department should clearly define how the commitment would be interpreted in the context of Canada's national circumstances. We also found that the Department had not considered all tax measures in support of the G20 commitment. We recommended that the Department develop a plan to ensure it reviewed all relevant tax measures that apply to the fossil fuel sector, including relevant benchmark tax measures. The Department agreed and committed to a plan to complete its review of benchmark tax measures by the end of 2018.

3.23 In our 2017 audit report, we also brought to Parliament's attention a subsequent event:

> On 22 March 2017, the government released Budget 2017, which proposed the following reforms to two fossil fuel subsidies discussed in [an exhibit of the 2017 audit report]:
>
> - Modify the accelerated deductibility of expenses for successful oil and gas exploratory drilling (100-percent deduction in the year incurred) by treating them as Canadian development expenses, which are deductible at a rate of 30 percent annually.
> - Remove the tax preference that allows small oil and gas companies to reclassify Canadian development expenses as immediately deductible Canadian exploration expenses when they are passed on to flow-through share investors.

3.24 The Department of Finance Canada defines tax subsidies for fossil fuels as those federal tax expenditures that provide preferential tax treatment that specifically supports the production or consumption of fossil fuels.

Recommendation

3.25 Our recommendation in this area of examination appears at paragraph 3.30.

Analysis to support this finding

3.26 **What we examined.** We examined whether the Department of Finance Canada

- clearly defined what inefficient tax subsidies were;
- included all relevant and reliable statistics, data, or qualitative information;
- assessed benchmark tax measures; and
- provided advice to the Minister on the basis of the Department's assessments of tax measures.

3.27 **Definition of "inefficient."** We found that the Department of Finance Canada did not clearly define criteria for inefficient tax subsidies for fossil fuels. Instead, the Department had a list of broad considerations that could be used when determining whether a tax subsidy was inefficient. The considerations were described in broad terms and were provided only as examples (Exhibit 3.2) and therefore were not sufficient to be considered a definition.

Exhibit 3.2 The considerations that the Department of Finance Canada could use for determining inefficiency were too broad

The word "inefficient" refers to a broad spectrum of considerations. The Department's analytical framework could include the following, for example:

- a detailed assessment of the need for policy intervention;
- an assessment of the effectiveness of a measure in meeting its policy objectives;
- economic impacts of all types (for example, favouring the production of certain types of activities at the expense of others);
- consideration of alternative delivery mechanisms;
- whether measures meet fundamental policy objectives of fairness, effectiveness, and simplicity;
- a review of gender or environmental concerns, as well as potential provincial impacts;
- an assessment of potential fiscal implications; and
- administrative, compliance, and legislative concerns.

Source: Department of Finance Canada

3.28 **Assessments of tax subsidies.** The Department of Finance Canada completed a review of a number of federal tax expenditures in 2016 and performed additional work on those specific to the fossil fuel sector that it considered subsidies. The Department assessed fiscal costs and elements of economic considerations when assessing the inefficiency of tax subsidies. These assessments also included some environmental and social considerations as part of the **strategic environmental assessment** and **gender-based analysis** of tax subsidies for fossil fuels. However, we found that these considerations were not sufficient to assess the integration of a tax subsidy's economic, social, and environmental sustainability—the three dimensions of sustainable development. They did not ensure that the three dimensions would be considered on an equal basis or over the long term.

3.29 **Identification of benchmark tax measures.** We found that the Department identified 12 benchmark tax measures specific to the fossil fuel sector. At the end of June 2018, the Department had begun to analyze 2 of the 12 benchmark tax measures that it had identified to determine whether they provided an advantage and therefore could be potential tax subsidies. The Department undertook this assessment as part of the action plan it prepared in response to a recommendation in our 2017 Spring Reports of the Auditor General of Canada, Report 7—Fossil Fuel Subsidies. According to the Department's action plan, the assessment of tax measures was to be completed by December 2018.

3.30 **Recommendation.** The Department of Finance Canada should develop guidance that clearly defines the criteria for determining the inefficiency of tax subsidies for fossil fuels, taking into account relevant and reliable evidence that integrates on an equal basis economic, social, and environmental sustainability over the long term.

The Department's response. *Disagreed. In the context of the G20 commitment, the term "inefficient" is not susceptible to the use of simple criteria, given the breadth of potential issues that may need to be considered. The Department of Finance Canada has instead developed a comprehensive framework to assess whether a tax measure may constitute an "inefficient fossil fuel subsidy."*

Strategic environmental assessment—The systematic and comprehensive process of evaluating the environmental effects of a policy, plan, or program and its alternatives.

Source: Strategic Environmental Assessment: The Cabinet Directive on the Environmental Assessment of Policy, Plan and Program Proposals: Guidelines for Implementing the Cabinet Directive, 2010

Gender-based analysis—The process by which a policy, program, initiative, or service can be examined for its impacts on various groups of women and men.

Source: "Gender-Based Analysis," Government of Canada, https://www.canada.ca/en/treasury-board-secretariat/services/treasury-board-submissions/gender-based-analysis-plus.html

The Department agrees entirely that the issues of economic, social, and environmental sustainability are important considerations. However, it would not be practical to develop assessments that systematically devote equal attention to economic, social, and environmental sustainability. Depending on the context of the analysis, some types of considerations may naturally be more prevalent and relevant than others. That being said, the Department consistently ensures that its analysis covers all relevant considerations.

Canada has now phased out most tax preferences for fossil fuel production. In order to learn from international best practices, Canada and Argentina recently committed to undergo peer reviews of inefficient fossil fuel subsidies under the G20 process. The feedback received will assist the Department as it continues to support the Government of Canada in reviewing measures that could be considered inefficient fossil fuel subsidies.

3.31 **Advice provided to the Minister.** The Department of Finance Canada provided advice to the Minister on inefficient tax subsidies for fossil fuels. We found that this advice was consistent with the assessments the Department prepared.

Conclusion

3.32 We concluded that the Department of Finance Canada provided advice to support decision making on inefficient tax subsidies for fossil fuels that was based on the Department's assessments. However, the assessments did not include all relevant and reliable statistics, data, or qualitative information because they did not integrate the economic, social, and environmental sustainability of the tax subsidies.

About the Audit

This independent assurance report was prepared by the Office of the Auditor General of Canada on tax subsidies for fossil fuels. Our responsibility was to provide objective information, advice, and assurance to assist Parliament in its scrutiny of the government's management of resources and programs, and to conclude on whether the actions of the Department of Finance Canada when assessing inefficient tax subsidies for fossil fuels complied in all significant respects with the applicable criteria.

All work in this audit was performed to a reasonable level of assurance in accordance with the Canadian Standard for Assurance Engagements (CSAE) 3001—Direct Engagements set out by the Chartered Professional Accountants of Canada (CPA Canada) in the CPA Canada Handbook—Assurance.

The Office applies Canadian Standard on Quality Control 1 and, accordingly, maintains a comprehensive system of quality control, including documented policies and procedures regarding compliance with ethical requirements, professional standards, and applicable legal and regulatory requirements.

In conducting the audit work, we have complied with the independence and other ethical requirements of the relevant rules of professional conduct applicable to the practice of public accounting in Canada, which are founded on fundamental principles of integrity, objectivity, professional competence and due care, confidentiality, and professional behaviour.

In accordance with our regular audit process, we obtained the following from entity management:

- confirmation of management's responsibility for the subject under audit;
- acknowledgement of the suitability of the criteria used in the audit;
- confirmation that all known information that has been requested, or that could affect the findings or audit conclusion, has been provided; and
- confirmation that the audit report is factually accurate.

Audit objective

The objective of this audit was to determine whether the Department of Finance Canada provided advice to support decision making on inefficient tax subsidies for fossil fuels that was based on analysis of all relevant and reliable statistics, data, or qualitative information.

Scope and approach

We examined the following aspects of the work performed by the Department of Finance Canada:

- the framework used for identifying inefficient tax subsidies for fossil fuels, and
- the provision of assessment and advice to support informed decision making.

This audit contributed to Canada's actions in relation to the United Nations' Sustainable Development Goal 16, which is to "promote peaceful and inclusive societies for sustainable development, provide access to justice for all and build effective, accountable and inclusive institutions at all levels."

We also separately examined advice provided to support decision making on inefficient non-tax subsidies for fossil fuels, which is the responsibility of Environment and Climate Change Canada. The findings from that audit can be found in the 2019 Spring Reports of the Commissioner of the Environment and Sustainable Development, Report 4—Non-Tax Subsidies for Fossil Fuels—Environment and Climate Change Canada.

Criteria

Criteria	Sources
To determine whether the Department of Finance Canada provided advice to support decision making on inefficient tax subsidies for fossil fuels that was based on analysis of all relevant and reliable statistics, data, or qualitative information, we used the following criteria:	
The Department of Finance Canada has an analytical framework for identifying inefficient tax expenditures that support or encourage the production or consumption of fossil fuels, which takes into account the linkages between economic, social, and environmental sustainability.	• G20 Leaders' Statement: The Pittsburgh Summit, 2009 • Department of Finance Detailed Action Plan to the recommendations of the Fossil Fuel Subsidies Report of the Spring 2017 Reports of the Auditor General of Canada, 2017 • Transforming Our World: The 2030 Agenda for Sustainable Development, United Nations, 2015 • 2017–2020 Departmental Sustainable Development Strategy, Department of Finance Canada
The Department of Finance Canada uses the analytical framework to identify inefficient fossil fuel tax expenditures, based on analysis of all relevant and reliable statistics, data, or qualitative information.	• G20 Leaders' Statement: The Pittsburgh Summit, 2009 • Department of Finance Detailed Action Plan to the recommendations of the Fossil Fuel Subsidies Report of the Spring 2017 Reports of the Auditor General of Canada, 2017 • Transforming Our World: The 2030 Agenda for Sustainable Development, United Nations, 2015 • 2017–2020 Departmental Sustainable Development Strategy, Department of Finance Canada
The Department of Finance Canada has provided advice to support decision making on inefficient fossil fuel tax expenditures that is based on the analysis developed for that purpose.	• G20 Leaders' Statement: The Pittsburgh Summit, 2009 • Department of Finance Detailed Action Plan to the recommendations of the Fossil Fuel Subsidies Report of the Spring 2017 Reports of the Auditor General of Canada, 2017 • Transforming Our World: The 2030 Agenda for Sustainable Development, United Nations, 2015 • 2017–2020 Departmental Sustainable Development Strategy, Department of Finance Canada

Period covered by the audit

The audit covered the period between 4 November 2015 and 30 June 2018. This is the period to which the audit conclusion applies.

Date of the report

We obtained sufficient and appropriate audit evidence on which to base our conclusion on 28 February 2019, in Ottawa, Canada.

Audit team

Principal: Heather Miller
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Recommendation

The following recommendation and response are found in this report. The paragraph number preceding the recommendation indicates the location of the recommendation in the report, and the numbers in parentheses indicate the location of the related discussion.

Recommendation	Response
Identification of inefficient tax subsidies	
3.30 The Department of Finance Canada should develop guidance that clearly defines the criteria for determining the inefficiency of tax subsidies for fossil fuels, taking into account relevant and reliable evidence that integrates on an equal basis economic, social, and environmental sustainability over the long term. **(3.27–3.29)**	**The Department's response.** Disagreed. In the context of the G20 commitment, the term "inefficient" is not susceptible to the use of simple criteria, given the breadth of potential issues that may need to be considered. The Department of Finance Canada has instead developed a comprehensive framework to assess whether a tax measure may constitute an "inefficient fossil fuel subsidy." The Department agrees entirely that the issues of economic, social, and environmental sustainability are important considerations. However, it would not be practical to develop assessments that systematically devote equal attention to economic, social, and environmental sustainability. Depending on the context of the analysis, some types of considerations may naturally be more prevalent and relevant than others. That being said, the Department consistently ensures that its analysis covers all relevant considerations. Canada has now phased out most tax preferences for fossil fuel production. In order to learn from international best practices, Canada and Argentina recently committed to undergo peer reviews of inefficient fossil fuel subsidies under the G20 process. The feedback received will assist the Department as it continues to support the Government of Canada in reviewing measures that could be considered inefficient fossil fuel subsidies.

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The Commissioner's Perspective

1. Aquatic Invasive Species
2. Protecting Fish From Mining Effluent
3. Tax Subsidies for Fossil Fuels—Department of Finance Canada
4. Non-Tax Subsidies for Fossil Fuels—Environment and Climate Change Canada