Intelligence MEMOS

From: Benjamin Dachis

To: François-Philippe Champagne, Minister of International Trade

CC: Provincial ministries of natural resources; Navdeep Bains, Minister of Innovation, Science and Economic Development

Date: June 16, 2017

Re: **FIXING STUMPAGE FEES IS THE SAW-OFF SOLUTION TO THE SOFTWOOD DISPUTE**

How Canadian provinces grant access to private lumber developers has become critical for the looming NAFTA negotiations. Provinces should look to reform how they charge for lumber access, not just to avoid a NAFTA challenge, but to increase revenues while not discouraging investment in the forestry sector. Governments should replace their flat resource fees by auctioning the right to access resources while also charging an annual fee on producers based on their net profits after taking account of the costs of production—in other words, a cash-flow tax.

The core issue is that Canadian governments own a lot of natural resources, such as lumber, oil and gas, and charge private companies fees to extract the resources. In the US, however, private landowners own most of the country's readily accessible natural resources. Those private owners of natural resources charge companies a market rate to extract the resource.

At dispute is whether Canadian governments are under-charging private companies to harvest lumber on provincial land. British Columbia, for example, charges a fixed fee called a stumpage rate, that some in the US claim is too low and subsidizes the Canadian industry. The stumpage fee formula is similar to what many provinces charge as a royalty on oil and gas production: a fixed fee per unit of production.

The idea of using cash-flow taxes instead of flat fees can be applied to more than natural resources. The federal government also manages the wireless telecoms spectrum that telecommunications companies must use to offer mobile phone services. Ottawa auctions off the right to access the spectrum. The winning bidder must then pay an annual fee to use that spectrum every year. Wireless spectrum is simply another scarce natural resource the government manages.

Resource taxation systems, both natural and otherwise, should concern themselves only with getting the maximum value out of the resource without discouraging the investment and effort required to develop the assets. A system that relies on a gross output or value tax doesn't meet either of these goals. A fee too high discourages investment. Too low a fee is a subsidy. The problem isn't the rate; it's the design of the tax.

Governments should tax only above-normal returns on investment, therefore not discouraging investment. Auctions are, in principle, the purest and most efficient way to do so. However, economic and political risks and a lack of competition in some places erode auctions' revenue-raising potential.

Many governments, both in Canada and around the world, supplement auctions with cash-flow taxes. These taxes apply to all revenues minus costs measured on a cash rather than accrual basis. This better design means that resource companies pay a high tax rate on cash flows but still have a strong incentive to invest.

If provinces charged a cash-flow tax along with auctioning the right to lumber, the US claims that Canada is subsidizing the sector would have little merit.

Canadian provinces can collect more revenue, avoid a NAFTA challenge, and not harm investment in forestry if they replace their distortive gross-revenue stumpage fees with a better designed system of auctions and cash-flow taxes.

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