



True North In Canadian Public Policy

Commentary

May 2014

The Natural Resource Sector: Economic Opportunities, Policy Challenges*

Brian Lee Crowley

Introduction: Canada's Greatest Endowment

A lot of people will tell you that Canada is a lucky country. Why? Because of its fantastic endowment of natural resources, including water and agricultural land as well as minerals, oil, and gas.

But while our natural resource endowment is indeed a wonderful benefit to Canada and Quebec, the real reason we are lucky, and the reason why the world beats a path to our resources, is not chiefly due to the resources themselves. What makes that endowment almost uniquely valuable in the world is that it exists within another vastly more important endowment of rules, institutions, and behaviours.

Consider that many of the world's wealthiest societies, be it Switzerland or Japan or Singapore or Taiwan or Germany or many others I could name, have no natural resources to speak of.

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* *The text of this Commentary is taken from a speech given by Brian Lee Crowley to le Cercle de la finance internationale in Montreal, Quebec on May 15, 2014.*

On the other hand, economists often talk about the curse of natural resource wealth because many of the societies that are blessed with such wealth do not know how to control it. Like many a lottery winner they are ruined by their good fortune. Just think of Nigeria, Venezuela, Indonesia, Angola, Algeria, Russia, or Saudi Arabia and ask yourself if you would trade living where you are to live there. And by the way, the natural resource curse is not limited to the developing world. Louisiana has one of the best natural resource endowments in the United States, and it consistently ranks near the bottom of all the states on most measures of social and economic progress. On the other hand many of the wealthiest states in the union, such as Massachusetts or Connecticut or Florida have no natural resources to speak of.

What makes the difference? It is all chiefly due to that endowment of institutions and behaviours I talked about. In Canada on the whole, with some exceptions I will mention, we have the full set of institutions and behaviours that as a matter of empirical and historical fact confer economic success.

I will tell you what I think it entails: the rule of law, independent judges and reasonably speedy and reliable resolution of disputes, the enforcement of contracts, the absence of corruption among government officials and the police, respect of private property, a moderate, predictable, and stable taxation and regulatory burden, a stable currency that keeps its value, responsible public finances, freedom to trade both domestically and internationally, a well-developed work ethic, and a refusal to resort to violence to resolve political disagreements. That is the greatest endowment that we have.

Now let's think about this idea of the nesting of a rich natural resource endowment inside this endowment of rules, institutions, and behaviours that I have just described. Companies can invest billions of dollars to unlock opportunities, such as the Alberta oil sands or Quebec's minerals, reasonably secure that they know the fiscal, regulatory, and contractual conditions they will face over a period of years sufficient to recoup their investment and make some money. They know they will not be extorted by megalomaniacal presidents or state-sanctioned gangs of thieves. They know their investment will not be nationalized overnight on a change of regime. They know that they are not in competition with favoured state corporations that will take a share of their business with no compensation, or be given access to opportunities on more favourable conditions than foreign investors. They know they can sell their product wherever they can get the best price and they can repatriate their profits in real hard currency.

Contrast this with Venezuela, Russia, Iran, or Argentina.

This may all help you to understand why, while it costs about \$20 to extract a barrel of oil in Saudi Arabia and can cost as much as roughly \$80 to extract one from the oil sands, oil companies from around the world are vying for the opportunity to invest in and develop that resource here. Its institutional context makes it more valuable than the same barrel elsewhere.

The Power of Policy

Note that we don't have to compare Canada with Russia or Iran to see the power of getting the political, fiscal, legal, and regulatory framework right. We have lots of fruitful comparisons from Canada itself.

Consider that when the oil and gas industry was in its infancy in the west, it was centred in Saskatchewan, not Alberta. Moose Jaw was to be what Calgary eventually became. But then a government came to power in Saskatchewan that changed the institutional context, increased the tax and regulatory burden and preferred to see resources developed by state-run corporations. The result was a rapid exodus of the industry to Alberta, which was more welcoming.

Then 60 years later the situation was reversed. The Alberta government decided it wanted to increase its share of oil and gas revenues and changed the regulatory and fiscal rules. Investment started to dry up and

shift to Saskatchewan, now a jurisdiction committed to exactly the kind of stable, friendly policy environment that huge investments of capital with long pay back periods require. The Alberta premier of the day was affectionately known next door as the best economic development minister Saskatchewan ever had. Alberta was forced to backtrack, but the relationship with the provincial government remains cool.

Something very similar happened in the province of Quebec, with oil and gas and mining. On the oil and gas side I think it is fair to say that the reluctance of both governments and public opinion to embrace petroleum exploration and development has made the industry reluctant to invest here. That meant that by the time the government got around to understanding that its fiscal position, among other things, made it prohibitively expensive to forgo exploration, it could only attract relatively junior players and even then only if the provincial government shouldered the lion's share of the risk. While in opposition the Liberals made clear they felt the risks were too high and that government shouldn't be a partner in the exploration around Anticosti. However now that they are in power if they cancel the agreements they only add to investor uncertainty. The decision they make will reverberate among the few investors still willing to envisage putting their money here.

Consider also that the only real commercially viable natural gas discovery made so far has essentially been stopped in its tracks: The Charest Liberals temporized by passing the hot potato to the Bureau d'audiences publiques sur l'environnement (BAPE) and an environmental review. The PQ was more aggressive and introduced de facto expropriation legislation (Bill 37) that died on the order paper when the election was called. This is exactly the opposite of the behaviour that unlocks investment in natural resources.

In mining, where Quebec has far more experience and an established track record, the government's revisions to the fiscal framework for mining were so ill received by the industry that Quebec tumbled from first place in the Fraser Institute's annual ranking of global mining jurisdictions from 2007/09 to 21st this year,¹ a stunning loss of competitiveness caused entirely by four attempts over the intervening years to revise la Loi sur les mines and two overhauls of the tax regime governing mining. And that loss of competitiveness is affecting investment levels. Last October, l'Institut de la statistique du Québec forecast a fall of 10 percent in mining investment in Quebec over the course of the year. That's the first decline in a decade. Newer data show that l'institut was too optimistic, with investment in fact declining by over a third, while exploration and development spending have fallen even more. Not to put too fine a point on it, this is a classic case of ill-advised government policy driven by an insatiable appetite for revenue and an inadequate understanding of the conditions that will unlock the kind of capital investment I have mentioned.

At a time when Quebec is being urged, including by the federal minister of finance, Joe Oliver,² to develop its natural resources, and Quebecers might therefore be asking themselves whether that is a road they want to take, it might be worthwhile to open a parenthesis here and refute some common misconceptions³ about the natural resource economy and its desirability relative to, say, manufacturing. The natural resource economy is not low-value added. On the contrary, manufacturing is now fully globalised and it represents the part of the process from conception to final product where the least value added is found. In the natural resource industry we are not in competition with developing countries' wages, because it is the global value of these highly desirable commodities that drive the industry, not wages. Moreover Canada is not only a major exporter of resources, but also a major importer, as people who work in Quebec's aluminum industry can tell you.

The natural resource sector is not highly cyclical. Manufacturing is much more cyclical in its effects on the economy than natural resources. Nor do natural resources contribute to regional disparities within Canada because they are widely distributed across the country although as I have explained that does not mean that all jurisdictions are equally successful in seeing them developed. Finally, contrary to the Dutch disease thesis, natural resources give little evidence of affecting our exchange rate, and the manufacturing industry in Canada specifically recognizes natural resource development as their biggest opportunity.⁴

Global Opportunities

We've talked a fair bit about institutions and capital in the context of natural resources. Now let's talk about opportunity in a bit more detail.

Of the 7 billion people in the world, only about half of them live in cities. But by 2050, according to the UN, the world's population will have increased by 2.3 billion, whereas the population of the world's cities will have increased by 2.6 billion. All of the population increase over the next 40 years will take place in cities, and another 300 million people will move from rural areas to the cities.

According to Paul Romer, one of the world's leading economists, all this means that there is a serious shortage of cities in the world.⁵ He points out that much effort is spent trying to tear down the barriers to trade between countries on the grounds that this will increase the world's wealth by a few percentage points. But you pull more people out of poverty faster by simply moving them from the country to the city. Look no further than this for the explanation of the explosive growth of cities throughout the world and especially in the developing world.

Moreover this rapid urbanisation is the chief explanation as to why these societies are able to grow so quickly compared to the west. We already have gone through the transition; they are on the way.

The effect of urbanisation on workers' incomes in the developing world is startling. Workers in cities earn a third more than their nonurban counterparts. Every time you add another million people to a city's population, you increase the wage level of everyone living there by 15 percent, so the growth is self-reinforcing.

According to the *National Post*, under the government's current plan China is to build 36 million affordable homes between 2012 and 2015, and even that may not be enough.⁶ That is the equivalent of building one house for every single Canadian over those three years.

As the Post notes, "All of these houses will require an awful lot of timber, concrete, copper wire, and other commodities".⁷ That is only a tiny slice of the opportunity for resource-exporting Canadian companies and their investors. China's oil consumption alone will rise from about 7 million barrels a day today to over 12 million.

But China won't be the only one bidding for our oil and other resources. China, like many other major consumers, is acutely aware that 80 percent of the world's oil supply is controlled by state corporations and comes from countries with various forms of political and other instability. Canada is the only major industrialized country that projects a significant increase in its oil exports over the coming decades, we are an oasis of stability, and our oil resource is increasingly recognized as both the largest in the world and extractable in highly dependable conditions and quantities. Countries around the world will be willing to pay a premium for what Canada has to offer. And it won't just be oil: Rio Tinto expects global copper consumption over the next 20–30 years, for instance, to exceed the total historical consumption to date.⁸

But now we come face to face with the nightmares that haunt those of us thinking about Canada's strategic interests and the likely sources of our future prosperity. For every one of the opportunities I have described requires us to increase our capacity to develop our resources and to move them to market. As we are seeing, for example with the debates over Keystone and Northern Gateway and over pipeline expansion and shale gas here in Quebec, we must now all come to terms with a new reality, namely that the old consensus that well-managed natural resource development projects are in the national interest is breaking down. How we respond will perhaps be the single largest influence on our future prosperity and national power.

Creating a Consensus

At exactly the moment when resource investment and development seem poised to take Canada to unheard of levels of prosperity, we are discovering the weakness of the institutions we have created to manage such growth in the public interest. Many of these institutions are federal.

Take the National Energy Board (NEB). An administrative tribunal, it is premised on the idea that Canadians favour the development of their resources, but want that development to proceed in accordance with high standards of safety, environmental protection, and social responsibility. Technical experts, paid for by the state, subject things like pipeline proposals to searching analysis and criticism, ensuring that they meet our standards before proceeding. In their analysis they are aided by a hearing process that allows the gathering of more, and more complete information about proposed projects.

But increasingly a vocal minority sees these regulatory tribunals not as a place to ensure that the rules are followed when we develop our resources, but as a place to argue that such development ought not to be allowed at all.

That, however, is a political and a moral argument that such agencies are not equipped to deal with. Disagreements about whether projects meet our standards can usually be resolved by science and reason. Disagreements over values and beliefs, about whether a pristine environment ought to trump economic growth and job creation, are properly resolved – indeed can only be resolved – in the political arena. We have to separate the question of whether we want natural resource development from the one about whether specific projects play by the established rules.

The stakes are enormous. Under the current dispensation, thousands of people can sign up to participate in the NEB's hearings, causing serious delays while manifestly not contributing to the tribunal's goal of ensuring a reasoned consideration of the project's merits.

With Canadian oil and gas production on track to exceed pipeline capacity to markets within a few short years, the successful blocking of new pipelines would have the effect of stranding new production and the forgoing of billions of dollars of investment and thousands of new jobs across Canada. Allowing such hijacking of the regulatory process allows a vocal minority to achieve indirectly what they could likely not win through legitimate democratic debate: the power to block natural resource development.

I believe that a large effort is needed to recreate a new national consensus, an effort that engages Canadians and assures them that they can have confidence that such development in Canada will be carried on in an open and accountable manner, to the highest environmental and ethical standards.

The old days of simply being able to force these things through because they were too big to fail and too important to obstruct are over. The time is upon us when we must decide whether we want to continue to fight rearguard actions against politicized minorities with major resources and the ear of the Canadian public, or if we are going to get the Canadian public on board and rob the minority for whom development is always to be opposed on principle of the audience that gives them political power in Canada.

The Duty to Consult and Accommodate

Aboriginal people represent a related but quite distinct problem on which I can do no more than touch lightly. A combination of unextinguished Aboriginal title, an activist judiciary breathing new life into treaties, as well as the elevation of such rights to constitutional status has created an ill-defined Aboriginal right to be consulted and accommodated and to some degree to be involved in and compensated for natural resource

development. The very tentativeness with which I have stated the issue helps us to understand the problem created. No one knows how extensive these rights are, who is entitled to exercise them, or how we are to distinguish claims with a good chance of success from the spurious and the exaggerated. At the same time the First Nations and Inuit have enjoyed an impressive, indeed an almost unbroken, string of court victories in seeking to vindicate their rights.

Again the old system of governments and industry bulldozing opponents is coming to an end, and probably rightly so. The simple fact of the national interest favoring such projects does not and cannot mean that we can simply wish away the newfound power of First Nations and Inuit. New accommodations must be found. And I must tell you frankly that agreements that have been struck, with for example the Gwich'in, the Inuvialuit, the Cree in northern Quebec, and elsewhere; they show that agreements are there to be made. Indeed Aboriginally-owned corporations, driven by the natural resource wealth to which they increasingly have access, will within a few short years almost certainly be numbered among the very largest corporations in Canada.

If we want to reduce the terrible costs in negotiation, uncertainty, and delay that we are increasingly encountering, we must find ways to engage First Nations positively, to help them to overcome their distrust and their fear of being taken advantage of. I can tell you I was invited into the offices of the Assembly of First Nations to help them think through what the outlines might be of a standardized approach to natural resource development that would relieve so much of the uncertainty for developers while assuring the Aboriginal people of Canada that development can and will redound to their benefit. The work that has arisen from that meeting now occupies a major part of our efforts at my institute.

Indeed when you consider the problems of a future of labour and skill shortages and the fact that Aboriginal people are the youngest population in the country, or you consider that natural resources are usually found in remote rural areas, precisely where many Aboriginal reserves are to be found, and you put all that together with a new generation of Aboriginal leadership like Shawn Atleo, Manny Jules, Clarence Louie, and Calvin Helin, people who want to break the cycle of dependency in which so many Aboriginal Canadians have been trapped, and we have the ingredients to use the natural resource boom to also help us break out of pathologies that have trapped us all in relations between Aboriginals and non-Aboriginals. The old incrementalism will not do.

For some time now Ottawa's attitude has largely been to let Aboriginal people and developers battle it out in the courts and hope for the best. Just as with the environmental movement, this is no longer good enough when the stakes for Canada are so high. Unlike many Canadians who believe that relations with First Nations are a morass into which we sink billions to little effect, I see a new and more positive era dawning. But we cannot be passive; we must seize these opportunities and develop them.

Conclusion

We have what the world wants and needs, not just in our resources, but in the society and institutions that make their stable, safe, and reliable production possible, and in the people whose energy and intelligence have been so good at taking nature's endowment and turning it into products that enrich the lives of people all over the world. Some of those institutions and behaviours are threatened, however, by politically generated uncertainty and this puts at risk our ability to exploit successfully our second most important endowment.

Canada, including Quebec, is and can continue to be a lucky country. But as a wise man once said, people make their own luck and it is up to us to continue to make ours.

Endnotes

- 1 Accessible at <http://www.fraserinstitute.org/uploadedFiles/fraser-ca/Content/research-news/research/publications/mining-survey-2013.pdf>.
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- 6 MJ Deen and Nicholas Ward, 20 February 2012, “China Pivots Its Growth Strategy to Focus on Domestic Consumption,” *National Post*.
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About the Author

BRIAN LEE CROWLEY

Brian Lee Crowley has headed up the Macdonald-Laurier Institute (MLI) in Ottawa since its inception in March of 2010, coming to the role after a long and distinguished record in the think tank world. He was the founder of the Atlantic Institute for Market Studies (AIMS) in Halifax, one of the country's leading regional think tanks. He is a former Salvatori Fellow at the Heritage Foundation in Washington, DC and is a Senior Fellow at the Galen Institute in Washington. In addition, he advises several think tanks in Canada, France, and Nigeria.

Crowley has published numerous books, most recently *Northern Light: Lessons for America from Canada's Fiscal Fix*, which he co-authored with Robert P. Murphy and Niels Veldhuis and two bestsellers: *Fearful Symmetry: the fall and rise of Canada's founding values* (2009) and MLI's first book, *The Canadian Century*; *Moving Out of America's Shadow*, which he co-authored with Jason Clemens and Niels Veldhuis.

Crowley twice won the Sir Antony Fisher Award for excellence in think tank publications for his health care work and in 2011 accepted the award for a third time for MLI's book, *The Canadian Century*.

From 2006–08 Crowley was the Clifford Clark Visiting Economist with the federal Department of Finance. He has also headed the Atlantic Provinces Economic Council (APEC), and has taught politics, economics, and philosophy at various universities in Canada and Europe.

Crowley is a frequent commentator on political and economic issues across all media. He holds degrees from McGill and the London School of Economics, including a doctorate in political economy from the latter.



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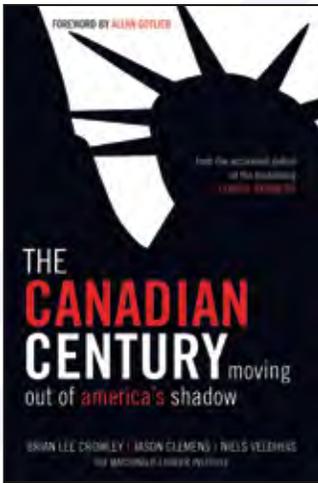
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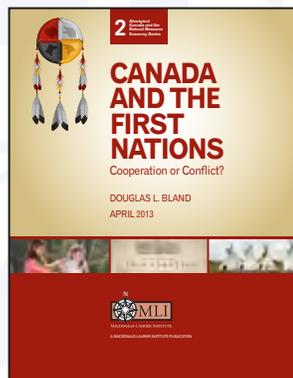
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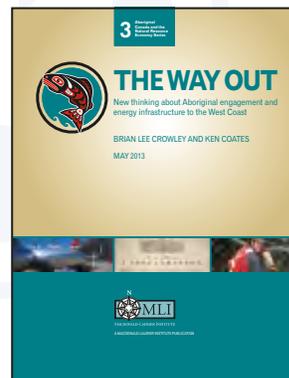
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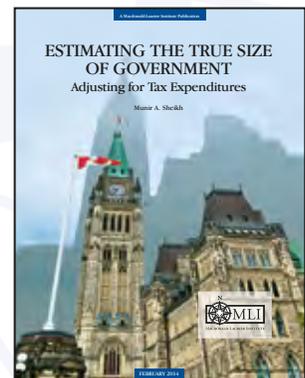
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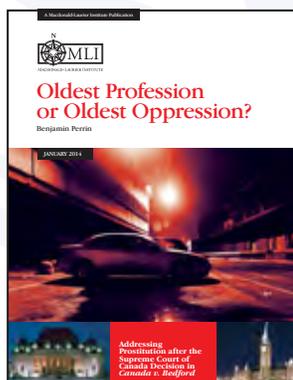
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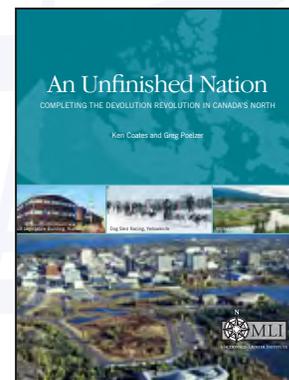
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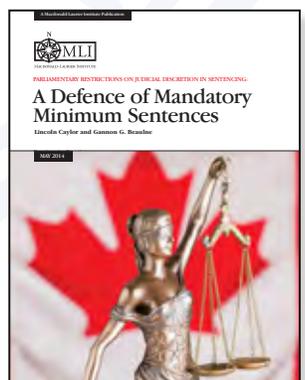
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