



The Case for Using Cap-and-Trade Revenues For Reducing Corporate Marginal Tax Rates

Summary

August 6, 2009 – Under a cap-and-trade program to limit greenhouse gas emissions, emissions allowances would acquire monetary value. Auctioning allowances would provide government revenue that could be used to reduce the overall economic drag exerted by higher energy prices. Auction revenue could make up for reductions in the corporate tax rate, and be used to remediate the impact of the price rise on the poor. An alternative approach for the use of the allowances is “grandfathering,” in which allowances are given to companies in selected sectors of the economy. Such grandfathering could result in windfall profits for stockholders of those companies but would offer no such benefits to companies that did not receive the grandfathered allowances.

Background

Under a cap-and-trade system, allowances are made available for the amount of carbon (or carbon dioxide equivalent) that can be emitted into the atmosphere as a result of regulated economic activities. There are a number of different approaches to cap-and-trade architecture, each with different economic and environmental consequences.

Regardless of the approach, when governments limit a resource, its value increases. Such limitations send a price signal about that resource, and as a result, consumers modify their behavior and take steps to avoid the increased costs. Market-based carbon reduction proposals would assign a value to carbon emissions. Consumers – including businesses – would then pay higher prices because the cost of the emission allowances would be added to the costs of production.

According to economists, the most efficient approach to reducing carbon emissions would be to impose tax on carbon accompanied by a reduction in distortionary taxes such the payroll tax or marginal corporate income tax. This approach would be revenue-neutral, since the revenues from the carbon tax would be used to cover the government’s revenue loss associated with the reduction in a distortionary tax.

But while economists might recommend a carbon tax as the “best” and most “efficient” way to reduce our emissions of greenhouse gases, most also acknowledge that a carbon tax is politically unfeasible today. This memo, therefore, looks at what economists generally agree is the next most efficient model – reducing carbon emissions using cap-and-trade with a “safety valve.”

Cap-and-Trade with a Price Collar

Cap-and-trade with a price collar adds a critical element to the basic cap-and-trade system by creating an allowance price cap, or “safety valve,” and a price floor to spur investment and technological innovation. The price cap would specify, over any given period of time, a maximum market price at which the government would step in and sell additional allowances *to prevent the price from rising any further*. The price cap could escalate over time, thus driving steadily more stringent emissions reduction efforts, while at the same time preventing disruptive price spikes. The collar mechanism provides regulated industries, consumers and the economy at large with certainty and predictability about the future cost of allowances.

Under either plan – cap-and-trade with a legally binding cap, or cap-and-trade with a collar or safety valve – the value of the allowances could be substantial due to the ubiquity of carbon in the US economy. This leads to the important question of how the distribution of these allowances should be handled.

Allowances: Should They Be Auctioned By The Government or Given Away?

There are two basic ways to distribute the allowances: auctioning them or giving them away, which is also known as “grandfathering.”

Auctioning allowances would allow the proceeds to be used to reduce marginal corporate tax rates or other distortionary taxes, as well as to assist the poorest part of the population in paying higher energy prices. If the allowances were given away, revenue from their sale or auction would be forgone by the federal government, which would eliminate the financing of a reduction in the rate of distortionary taxes.

Other Uses of Auction Revenues

There are a number of compelling purposes for which the revenue from an auction of the allowances might be used.

- New technologies are the ultimate solution to the climate change issue; revenues from the sale of allowance should be dedicated to an aggressive research, development and deployment program for zero and low-carbon technologies.
- Funds could also be directed at those parts of the population disproportionately affected by the adoption of a climate change proposal, including those who work in carbon-intensive industries, e.g., coal mining, as well as those at the lower end of the income scale who will be adversely impacted by higher energy prices.
- And, since climate change is a global problem, it would also make sense to use auction revenues to engage developing countries on projects and policies to foster reductions in greenhouse gas emissions from their economies.

Conclusion: Auctions Plus Tax Reductions Offer the Most Efficient and Effective Solution for the Environment and the Economy

Every climate change cap-and-trade approach will reduce the Gross National Product (GDP) by some amount, an effect resulting from the drag exerted by higher energy prices, which would now include the cost of carbon allowances. An economically efficient program would be one which achieves the desired level of greenhouse gas emission reductions while reducing GDP *the least*. Economists generally argue that the best way to reduce economic drag would be to reduce taxes, such as the corporate tax, that have a distortionary effect on the economy.

The taxes generally seen as the most distortionary are the payroll tax, the capital gains tax and the corporate income tax. The Congressional Budget Office, in recent analyses, suggested that a portion of revenues from the sale of allowances could be used to reduce the marginal corporate tax rates, while another portion could be used to address the equity issues raised by higher energy prices. In general, auctioning carbon allowances and recycling revenue to reduce corporate marginal tax rates would appear to have benefits in terms of reducing overall costs and creating value for the economy as a whole and for a broader array of businesses, than the alternative of grandfathering allowances that will provide benefits only to selected companies and industries.

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