

# Carbon taxes are fine, but a cap-and-trade program is better

BY KYLE DANISH AND MEGAN CERONSKY

**W**e come not to bury the carbon tax, but to praise it. We agree that a carbon tax could offer predictable costs, administrative simplicity, and an opportunity to offset other taxes. Our point is simply that a cap-and-trade program can do all these things, and more.

## Price predictability

As traditionally conceived, choosing between a carbon tax and a cap-and-trade program involves a trade-off between price certainty and emissions certainty. A carbon tax establishes a transparent and predictable price-to-emit, but the resulting emissions are uncertain. By contrast, a conventional cap-and-trade approach establishes a transparent and predictable cap on emissions, but the resulting price-to-emit is uncertain.

Why choose? One of the climate change policy approaches considered by Congress in 2008 was a hybrid cap-and-trade program providing both price and emissions certainty. Under a hybrid approach, the government uses allowance auctions to establish a minimum and a maximum price-to-emit while maintaining a long-term emissions cap. This approach was reflected in both the Boxer-Lieberman-Warner bill (S. 3036) and the Dingell-Boucher discussion draft.

To establish the minimum price, the government reserves some allowances otherwise available under the cap and auctions them at a minimum price established in the legislation. If the reserve allowances are not sold (because emission reductions are cheaper than expected), the government withholds them, thereby tightening the cap and making the reserve price the market floor.

The government also auctions allowances taken from future year caps at a maximum price established in the legislation. Regulated entities will purchase these allowances only if market allowance prices exceed the legislated maximum. If entities buy these extra allowances, emissions can exceed that year's cap. However, because the additional allowances are drawn from future years, the program forces correspondingly lower emissions in the later years, thereby preserving the long-term emissions cap.

## Transparency and administrative simplicity

Carbon tax advocates laud the comparative transparency and simplicity of their approach. Yet in making their case, they seem to start from a Platonic ideal. We are unaware of any major tax program that is devoid of carve-outs, loopholes, or give-aways.

Clearly, both a carbon tax and a cap-and-trade program present design challenges. However, environmental policymakers have much more experience with and knowledge of cap-and-trade programs than pollution taxes. In light of the wide-ranging impacts of any climate change legislation, the value of this

institutional knowledge should not be overlooked.

To be sure, a cap-and-trade program would require oversight of a new market. The European Union Emissions Trading System (EU ETS) yielded a \$50 billion market in 2008. However, although there has been criticism of the EU ETS, financial improprieties have not been an issue. In any event, however complicated the financial arrangements are behind a trading market, the *environmental* requirements remain simple to enforce: if you emit, you must surrender allowances or face a penalty.

## Allowance allocation

Tax advocates have leveled their harshest criticism on allowance allocation, decrying alleged horse-trading and windfalls. By contrast, they favor the simple taxation of all emissions and propose using the revenues to reduce other, inefficient taxes. Yet these revenue-raising goals can also be satisfied through a cap-and-trade program in which allowances are auctioned. President Obama, a cap-and-trade supporter, has advocated auctioning 100 percent of allowances and using the revenues for clean energy programs. Some groups are advocating a "cap-and-dividend" program, in which auction revenues are recycled to the public in the form of tax rebates.

There are good reasons, however, to consider allocating at least some portion of the allowances. Targeted allocations offer opportunities to address the initial impacts of a new emissions limit. These impacts could be severe, for example, for regions that have relied on coal-fired electricity and for companies in internationally competitive markets. Allocations could help ease their transition into a carbon-constrained economy. Indeed, even if the United States were to adopt a carbon tax, we would expect the use of similar tax mechanisms, such as marginal tax rates and exemptions, to moderate the disparate impacts of the regulation.

## Politics matter

We believe a carbon tax should be evaluated on its policy merits. Even so, it is important to note that a carbon tax would be . . . well, a tax. Were a carbon tax clearly the superior approach to addressing climate change, it might be worth adding its significant baggage to what already will be a difficult political lift. However, for all the above reasons, it is not. In our view, it makes sense to understand fully the benefits of a carbon tax—and use that understanding to design the best possible cap-and-trade program.

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