

Congressional leaders and the Obama administration have made comprehensive climate change legislation one of three top priorities for the 111th Congress. The climate bills that have been introduced by members of Congress are varied, but fall generally into three camps: cap and trade, carbon tax, or a hybrid of the two systems.

Most of the proposals would set a “cap,” or upper limit, on allowable carbon emissions in the United States. That cap would slowly tighten over time. The systems differ in the ways they would keep polluters under those caps.

*Cap and trade* would set up a new market for firms to buy and trade a limited number of pollution permits. Regulated companies would be required to turn over to the government pollution permits for each ton of carbon that they emit into the atmosphere. Companies with insufficient permits to cover their pollution for a given period could face stiff penalties. Designers of cap and trade systems foresee a market in derivatives based on the pollution permits; this market would need regulation and oversight to avoid the manipulation and excessive speculation experienced in other derivatives markets<sup>1</sup>.

*Carbon tax* and some of the *hybrid systems*, which can be thought of as a “cap without trade,” would not create a new market and instead would require companies to buy a non-tradable pollution permit for each ton of carbon they emit. In both systems, the federal government, not profit-seeking traders in a market, would set a gradually rising price on carbon to meet emissions goals.

The stable and predictable carbon prices of a carbon tax or a hybrid system would help facilitate the transition to a clean economy by creating clear incentives for low-carbon investment<sup>2</sup>; fossil fuels would become progressively less economically attractive and low-carbon alternatives would become economically superior.

In a *hybrid system*, the levels of emissions reductions would be set by statutory law, and the responsible federal agencies (e.g. Environmental Protection Agency, Energy, and Treasury Departments) would be required to periodically review and increase the price of carbon to meet the mandated emissions caps.



## Costs passed on to consumers

Under either system, the cost of the pollution permits would be passed on to consumers in the form of higher prices for energy and a whole range of products that require energy for production<sup>3</sup>. Consumers are an important part of the solution; higher prices encourage consumers to look for energy cost savings. But many consumers cannot afford the substantial price increases required to curb global warming. In some proposals, consumers would be reimbursed for some or all of the price increase. When they are separately refunded these extra energy costs, consumers still respond to price changes when they make choices about energy consumption and products<sup>4</sup>.

“Now, the experience of a cap-and-trade system thus far is that if you’re giving away carbon permits for free, then basically you’re not really pricing the thing and it doesn’t work, or people can game the system in so many ways that it’s not creating the incentive structures that we’re looking for.”

~Barack Obama, Business Roundtable, March 12, 2009.

<sup>1</sup> Jonas Monast, Jon Anda, and Tim Profeta, “U.S. Carbon Market Design: Regulating Emission Allowances as Financial Instruments,” Duke University, February 2009.

<sup>2</sup> Metin Celebi and Frank Graves, “CO<sub>2</sub> Price Volatility: Consequences and Cures,” The Brattle Group, January 2009.

<sup>3</sup> “The Distributional Consequences of a Cap-and-Trade Program for CO<sub>2</sub> Emissions,” U.S. Congressional Budget Office, March 12, 2009.

<sup>4</sup> “How a ‘Climate Rebate’ Would Work,” Center on Budget and Policy Priorities, April 22, 2009.

## WHAT IS AN OFFSET?

Offsets are “get-out-of-jail-cheaply” coupons for polluters that may be included in climate legislation. Here is the idea: Carbon dioxide (CO<sub>2</sub>) is emitted by various sources all over the world, but, once it is in the atmosphere, the gas mixes uniformly. Thus, CO<sub>2</sub> from China is just as potent to the climate system as CO<sub>2</sub> from the United States. Theoretically, a company in the United States can emit a ton of CO<sub>2</sub> while “offsetting” its pollution by funding a project in China that reduces CO<sub>2</sub> by a ton, and the result will be a net zero CO<sub>2</sub> release, as compared to carbon emissions we might otherwise have expected in the future. The problem with offsets is twofold: first, a significant number of offset projects are thought to be false, and second, if U.S. companies can cheaply outsource their reductions, domestic investments in infrastructure and technology will be delayed and consequently the development and transition to a low-carbon economy will be stunted.

## Cap Without Trade: A Better Choice

FCNL urges Congress to pass fair and effective climate legislation. To best meet these goals, we support a simple and transparent emissions cap without trading that would require companies to pay for every ton of pollution they emit, and return a majority of the revenue to consumers. By putting a direct price on carbon, the government will begin to level the playing field for clean energy and include the environmental costs in the price of fossil fuels.

## Congress Debating Cap and Trade: Key Provisions

Several congressional leaders currently back cap and trade legislation. Nevertheless, many members of Congress have not made up their minds; some confide that cap without trade is their preferred system, but do not yet see the support they would need to take a public stand on their preference. **We need to give them that support.**

This year the climate debate is well underway, as the House kicked off by passing a cap and trade bill in late June. While cap and trade is not FCNL’s preferred mechanism, *curbing climate change* is paramount. We welcome the long-needed climate conversation and recommend that if a cap and trade system is chosen, it be improved by including the following elements:

### 1. Auction pollution permits

Under cap and trade, polluters must hold tradable permits to emit carbon pollution. Congress is debating whether these permits should be given away free to industry for decades or sold through government auction.

If the government gives away permits to polluters for free, a *de facto* system of wealth transfer from taxpayers to industry would be instituted. Since a company can sell its free permits on the carbon market, it would include this cost (the cash it *would have* received for selling the permits) in the price of its product which consumers must then pay. Therefore, even though the permits were given away for free, profits increase for industry while prices rise for consumers<sup>5</sup>.

Additionally, if the permits are given away for free, the government will have lost its ability to provide consumer relief, or make other investments, with carbon revenue.

2. **Refund the majority of pollution revenue back to consumers**  
Adding a price to carbon will affect low-income families more acutely since energy costs represent a greater fraction of their income (see above). However, refunding most of the carbon revenue back to consumers can transform an economically regressive system into a progressive system; low- to middle-income families will not see a change in their overall income<sup>6</sup>.

### 3. Eliminate or strictly limit “offsets”

The purpose of a cap is to reduce greenhouse gas emissions. But offsets offer a way out, allowing polluters to pay others to make reductions and get credit for those reductions. Offsets can undermine the integrity of the entire climate bill and delay the U.S. transition to a low-carbon economy, allowing industry to avoid actual emissions reductions for years<sup>7</sup>.

By their very nature, offsets are inherently uncertain (see box). The worthy goals of offsets, e.g. promoting responsible agricultural practices, should have *separate* incentives that do not undermine the carbon cap.



5 Peter Orszag, “Approaches to Reducing Carbon Dioxide Emissions,” U.S. Congressional Budget Office, testimony before the House Budget Committee, November 1, 2007.

6 Dallas Burtraw, Resources for the Future, testimony before the House Ways and Means Subcommittee on Income Security and Family Support, March 12, 2009.

7 John Stephenson, “Climate Change: Observations on the Potential Role of Carbon Offsets in Climate Change Legislation,” U.S. Government Accountability Office, testimony before the House Energy and Commerce Subcommittee on Energy and Environment, March 5, 2009.