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Cap-and-Trade: All Cost, No Benefit

By Martin Feldstein

The Obama administration and congressional Democrats have proposed a major cap-and-trade system aimed at reducing carbon dioxide emissions. Scientists agree that CO₂ emissions around the world could lead to rising temperatures with serious long-term environmental consequences. But that is not a reason to enact a U.S. cap-and-trade system until there is a global agreement on CO₂ reduction. The proposed legislation would have a trivially small effect on global warming while imposing substantial costs on all American households. And to get political support in key states, the legislation would abandon the auctioning of permits in favor of giving permits to selected corporations.

The leading legislative proposal, the Waxman-Markey bill that was recently passed out of the House Energy and Commerce Committee, would reduce allowable CO₂ emissions to 83 percent of the 2005 level by 2020, then gradually decrease the amount further. Under the cap-and-trade system, the federal government would limit the total volume of CO₂ that U.S. companies can emit each year and would issue permits that companies would be required to have for each ton of CO₂ emitted. Once issued, these permits would be tradable and could be bought and sold, establishing a market price reflecting the targeted CO₂ reduction, with a tougher CO₂ standard and fewer available permits leading to higher prices.

Companies would buy permits from each other as long as it is cheaper to do that than to make the technological changes needed to eliminate an equivalent amount of CO₂ emissions. Companies would also pass along the cost of the permits in their prices, pushing up the relative price of CO₂-intensive goods and services such as gasoline, electricity and a range of industrial products. Consumers would respond by cutting back on consumption of CO₂-intensive products in favor of other goods and services. This pass-through of the permit cost in higher consumer prices is the primary way the cap-and-trade system would reduce the production of CO₂ in the United States.

The Congressional Budget Office recently estimated that the resulting increases in consumer prices needed to achieve a 15 percent CO₂ reduction -- slightly less than the Waxman-Markey target -- would raise the cost of living of a typical household by \$1,600 a year. Some expert studies estimate that the cost to households could be substantially higher. The future cost to the typical household would rise significantly as the government reduces the total allowable amount of CO₂.

Americans should ask themselves whether this annual tax of \$1,600-plus per family is justified by the very small resulting decline in global CO₂. Since the U.S. share of global CO₂ production is now less than 25 percent (and is projected to decline as China and other developing nations grow), a 15 percent fall in U.S. CO₂ output would lower global CO₂ output by less than 4 percent. Its impact on global warming would be virtually unnoticeable. The U.S. should wait until there is a global agreement on CO₂ that includes China and India before committing to costly reductions in the United States.

The CBO estimates that the sale of the permits for a 15 percent CO₂ reduction would raise revenue of about \$80 billion a year over the next decade. It is remarkable, then, that the Waxman-Markey bill would give away some 85 percent of the permits over the next 20 years to various businesses instead of selling them at auction. The price of the permits and the burden to households would be the same whether the permits are sold or given away. But by giving them away the government would not collect the revenue that could, at least in principle, be used to offset some of the higher cost to households.

The Waxman-Markey bill would give away 30 percent of the permits to local electricity distribution companies with the expectation that their regulators would require those firms to pass the benefit on to their customers. If they do this by not raising prices, there would be less CO₂ reduction through lower electricity consumption. The permit price would then have to be higher to achieve more CO₂ reduction on all other products. Some electricity consumers would benefit, but the cost to all other American families would be higher.

In my judgment, the proposed cap-and-trade system would be a costly policy that would penalize Americans with little effect on global warming. The proposal to give away most of the permits only makes a bad idea worse. Taxpayers and legislators should keep these things in mind before enacting any cap-and-trade system.

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