Does Cap and Trade Mean Tax and Spend?

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Last Wednesday, House Speaker Pelosi said "You cap and you trade so you can pay for ... investments in energy independence and renewables." Her views reflect the current cap-and-trade bills, which are just complicated taxes collecting money that they give away or spend.

Contrast this with what economists say. They praise cap and trade as market-based because it works according to a principle described by Arthur C. Pigou back in 1920. He invented a tax that is famous for working even though it's not used to increase spending.

Economists agree. The point of cap and trade is not to pay for green investments. The point is to raise the price of what is taxed, in this case carbon. The markets pass on the extra carbon cost to every car and every cup of tea in just the right proportion. Consumers, businesses and inventors then respond to market prices. That's why cap and trade is market-based; it's not because of trading.

We need both policies: government-supported green investment, and a market-based approach. But when the two become one policy, we stunt the market-based approach, and we fund green investment with a regressive tax—a tax on carbon. As I'll now explain, this stunting of the market-based approach is no small matter of stepping on pro-market toes.

The massive climate policies now contemplated could be hugely expensive—if done wrong. But such policies would likely be affordable—if done right. No one can doubt the former. But why should we believe in affordability? Look closely, and you discover Pigou once again.

The only credible estimates of cost for massive climate policies come from economic models. Most point toward an affordable cost. But those models all assume that climate policy is market-based and relies on Pigou's tax. Economists are not much bothered by this limitation, because they're sure the least-expensive policy would be mainly such a tax. But if we adopt some other policy—say, tax and spend—all bets are off. Or rather, you'll find most economists betting on a huge expense.

What would a massive market-based policy look like? NASA climate scientist James E. Hansen proposes the classic Pigouvian tax found in economic models. Take all the revenues, divide them by the number of U.S. citizens, and send each person an equal refund check. This proposal is equal parts tax and refund, with no spending.

According to researchers at MIT, a strong cap-and-trade tax would, the first year, cost a family of four roughly $4,000. Without the refund, that burden would cause a tax revolt. But with the refund, well over half the population receives more in refunds than they pay in taxes, because they use less carbon than average. Most others can easily pay for their larger carbon footprint—and they still receive a refund that completely covers the tax on average carbon use.

But Hansen's idea raises this old objection: "We'll just use our refunds to pay our carbon taxes, so there's no reason to change our carbon use." But remember that using 20 gallons less gas could save enough in carbon taxes to pay for a dinner out. And you still get your full refund.

So, in a nutshell, here's the economic view. To be affordable, climate policy must be mostly market based. That means raise the price of carbon with a carbon tax or cap and trade. And raise it high enough to change behavior. That implies huge revenues, much higher than appropriate for green investing. So give the money back, and let the market work. That avoids waste and heavy burdens, especially on the poor.

Using some small part of a carbon tax to pay for green investment would cost no more than using other funds. But don't say the point of cap and trade is spending. Poor Pigou would turn over in his grave.

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* Visit http://stoft.com/p/122.html for more information