

OPTIONS FOR PROTECTING HOUSEHOLDS IN CLIMATE POLICY

A State by State Analysis

A collaborative project of Chesapeake Climate Action Network, Fresh Energy, Montana Environmental Information Center, New Energy Economy, New York Public Interest Research Group, Ohio Citizen Action, and Penn Future.

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OVERVIEW

President Obama has called for a national policy to limit global warming pollution and create significant new investments and millions of jobs in clean and reliable energy technologies. In June 2009, the House of Representatives passed its version of climate and energy policy, a cap-and-trade bill called the American Clean Energy & Security Act (ACES). Now it is the Senate's turn to act. This paper looks at options to improve the final policy through auctioning pollution permits and returning the proceeds directly to American households.

In crafting the Administration's proposed policy, President Obama called for polluters to pay for carbon pollution permits through an auction and for the vast majority of the revenues to be returned directly to households through a tax credit to help them deal with rising prices, with the remainder to be invested in clean energy and transition assistance.¹ The President stated his position during the 2008 election and again once in office, including as recently as his mid-session budget review in August 2009.²

ACES diverges significantly from the President's proposal by giving away the vast majority of pollution permits to favored industries in the initial years of the program. It would create a complex scheme that combines direct payments, a vague requirement that electric utilities distribute the value of free permits to customers, and increases in the price of stocks in select companies in an attempt to protect households from rising prices. For most Americans, many of these indirect benefits will be unknowable and inaccessible and will not offset rising prices. According to the Congressional Budget Office (CBO), most households will see their net costs increase, with the largest burden falling on the middle class.³

The Senate has the opportunity to enact a policy that would provide a knowable, timely and direct rebate to

households facing rising prices, leaving most households financially better off or unharmed. Instead of giving away pollution permits to corporations, such a policy would auction permits, and refund the proceeds directly to the American people. This policy, which tracks more closely with President Obama's proposal, is most often called cap-and-dividend, although it is also referred to as cap-and-rebate or cap-and-refund.

Senators John Kerry and Barbara Boxer introduced the Clean Energy Jobs and American Power Act in September 2009. Their legislation follows the approach taken in ACES. The Committee on Finance has indicated that it will also develop a proposal dealing with the distribution of allowances and revenue. Senator Maria Cantwell has proposed a full auction with the majority of proceeds returned directly to citizens and the remainder invested in clean energy and related programs.⁴ Senate Majority Leader Reid has not announced a schedule for the full Senate to consider climate and energy policy.

This paper reviews economic reports, particularly the CBO's assessment of ACES and testimony and commentary discussing the legislation. It compares the unknowable, inaccessible and indirect household benefits of ACES and the Kerry-Boxer proposal to the knowable, timely and direct benefits found in cap-and-dividend and similar proposals. It highlights several policy insights, including that a direct benefit can better maintain the price signal on carbon throughout the economy, that a direct benefit is more likely to reach households than money or permits earmarked to select industries, and that the proposals industry claims will help households may end up costing more.

It includes new research from the Political Economy Research Institute (PERI) at the University

of Massachusetts showing that most households in every state would be better off with the direct benefit of a cap-and-dividend proposal. Further, the research shows that an auction could raise sufficient funding to fully compensate most households in all states for rising costs and fund investments in clean energy technologies and programs to address regional disparity in energy production and use. As one example, the PERI study shows that under a policy

scenario that auctions 100 percent of pollution permits (at a price of \$25 per ton of carbon dioxide) and returns 80 percent of auction revenue directly to households in per capita payments, most American households would be better off, with the median household of four receiving an annual net benefit of \$412. In addition, this policy would also generate \$30 billion each year to be spent on clean energy and to address regional variability.

WHAT IS A HOUSEHOLD “BENEFIT” IN ACES?

Understanding how much climate and energy policy will help or burden households requires that we look at both the new costs households will face and the benefits they might receive under any given policy. It is important to note that we are putting aside the enormous economic, health and environmental benefits of addressing climate change.⁵

It has been widely reported that the American Clean Energy and Security Act (ACES) will cost the average household about \$175 per year, or as many have said, “less than a postage stamp per day.”⁶ That number reflects net costs, including costs from rising prices for energy, goods and services, and benefits that flow to households. Specifically, it comes from an analysis of costs and benefits in 2020 by the Congressional Budget Office (CBO).⁷

By limiting carbon pollution, cap-and-trade creates scarcity and a valuable new product in pollution permits that will be worth hundreds of billions of dollars. Pollution permits, as a new cost, will make coal, oil and other polluting sources of energy relatively more expensive, while making energy efficiency, solar, wind and other clean energy technologies more competitive.

From the consumer perspective, some increased costs will be as obvious as the price of gas at the local filling station or an electric bill, while others will be less obvious, embedded in the cost of food, clothes, electronics, and other everyday products.

Under ACES, the impact on a particular household depends on the household’s income and direct and indirect energy consumption, but also on more obscure and difficult-to-know factors, including the policy decisions of 50 state public utility commissions over several years, the behavior of corporate middlemen, and the composition of a household’s investment portfolio.

Understanding those provisions of ACES that are intended to protect a household financially (again, putting aside the vital benefits associated with reducing climate change risks) involves a closer look at the workings of the legislation. It also raises the question, “What is a benefit?”

DIRECT PAYMENTS

ACES would pay out direct relief to lower-income households through energy rebates and tax credits. Qualifying households include those receiving benefits through the Supplemental Nutrition Assistance Program or through the Medicare Part D low-income subsidy, and those not participating in those programs but with income below certain thresholds. Payments in 2020 would amount to \$14 billion, according to the CBO.⁸

There is little controversy around the concept of helping lower-income households deal with rising everyday expenses through a knowable, timely and direct benefit. Energy prices hit lower-income households the hardest because energy costs make up a far larger portion of their budgets. ACES seeks to address this disparity with a direct benefit.

AN INEFFECTIVE WAY TO PROTECT HOUSEHOLDS

ACES allocates free permits (about \$42 billion in 2020, according to CBO) to utilities with instructions to pass those benefits on to customers. CBO estimates that \$14.5 billion of this would go to residential customers (with the rest going to businesses) and describes this as “relief to households.” This does not mean, however, that households will necessarily receive a check in the mail from their utility or even that this amount of consumer protection is guaranteed.

ACES does not specify how utilities should distribute the value of the free permits to customers. That responsibility is delegated to the public utility commissions in each of the 50 states. The benefit could be a check or wire transfer from the utility to a residential customer, or a reduced electric bill, or even an investment in energy efficiency and other programs that state regulators deem a benefit to households. Industrial customers are paid directly based on consumption, and CBO estimates these payments primarily benefit shareholders.

If utilities are allowed to pay customers a benefit by reducing their electric bill, it has the potential to increase the overall cost of the program. Government and independent economists warn that household consumers are not likely to parse their electric bill in search of a hidden benefit.⁹ If consumers do not have a reason to save energy and utilities do not have a reason to switch to cleaner energy technologies, more costly reductions will be required elsewhere to meet the law's emission reduction mandates. As a result, consumers will pay more for gasoline, heating oil and other products.

In short, this “benefit” may end up costing households more, and diminish the incentive for households and commercial customers to invest in cost-effective efficiency and renewable technologies.⁹

UNCERTAIN OUTCOME

Consumer advocates warn that in practice the value of this particular benefit may be skimmed by utilities as a windfall profit or used to fund investments counter to our environmental and economic goals.

The Center for Budget and Policy Priorities warns, “Depending on the strength of the regulators in a state, however, some of the funds still might not be used in optimal fashion or might go for overhead or turn up in utility companies' bottom lines.”¹⁰ Public

Citizen explains that these free allowances will “set up a legal fight in all 50 states' utility regulatory commissions on how exactly the money will be returned to families and how much utilities can skim off the top.”¹¹

The concern rests on the fact that hundreds of billions of dollars will be at stake over decades in a system that invites many interpretations, if not manipulation. In a paper entitled “Caution to Consumers,” Clean Air Watch offers this caution:

Consider the possibilities: What if a coal-burning power company argued to its local regulatory commission that building a new coal-fired power plant or upgrading an existing coal-fired power plant would “benefit rate payers?” Such a creative interpretation of the Waxman-Markey language would seem to turn the energy and climate legislation on its head – and yet it might be possible the way the bill is written. Instead, the allowances should be used for the direct benefit of consumers. They should not be used to extend the life of inefficient, polluting power plants or subsidize new conventional coal plants.¹²

In a hearing before the Senate Committee on Finance, Dallas Burtraw, an economist with Resources for the Future, stated, “The outcome at this juncture is uncertain and beyond the reach of legislative language included in [ACES].” He added, “In fact, there is great uncertainty about how the allowance value directed to local distribution companies will flow back to consumers.”¹³

CORPORATE PROFITS AND A REGRESSIVE ENTITLEMENT

The CBO identifies the most complex aspect of household benefits in ACES as “Allocation to Businesses and Net Income to Domestic Offset Producers.” It represents a substantial portion of the

benefit to households, but it may prove practically unknowable to those who receive it and inaccessible to most Americans.

This benefit is created because ACES directs a large portion of free permits (\$47 billion in 2020, according to CBO) to corporations and creates growth in the domestic pollution offset business. CBO assumes that this will lead to a windfall in corporate profits, higher stock prices and a benefit to households that own the relevant stocks.

Because wealthier households own more stock than others, CBO estimates that about 63 percent of the permit value conveyed to businesses would ultimately flow to households in the highest income quintile (average pretax income of \$259,600) for a gross average of \$885 per household in 2020. In contrast, households in the lowest income quintile (average pretax income of \$18,000) would receive only 5 percent of the relief targeted to businesses—a gross average of \$65 per household. For a family in the middle quintile (average pretax income \$63,400),

more than 30 percent (\$140 of \$440) of the benefit the CBO estimates ACES will deliver to offset rising costs (\$675) will come from stocks in 2020.¹⁴

However, the numbers alone are only one part of the story: To collect this benefit, a household must own the correct stock over the correct time, or possibly work for the correct company. If not, that family is out of luck.

To realize that they are getting this benefit, consumers must somehow distinguish the effect of carbon permit windfalls from the many other factors that cause stock values to rise and fall, whether they happen to own the stock outright or through a mutual fund.

It also means that a significant portion of a household's benefit will be tied up in stocks—including mutual funds and retirement accounts—where it will be unavailable to help offset rising costs of energy, goods and services. Its circuitous path through corporate middlemen will make the benefit unknowable and inaccessible to most Americans.

A BETTER POLICY:

AN AUCTION AND DIRECT BENEFITS

President Obama has proposed a very different approach to cap-and-trade that relies on an auction and the direct distribution of benefits to households. In his budget, the President proposed auctioning all permits and distributing 80 percent of the auction revenue directly to workers through the Making Work Pay tax credit. The President proposed that the remaining revenue be dedicated to transition costs and clean energy investments.

Many others, including Democrats, Republicans, conservative and progressive economists, and business leaders, have made similar proposals. What these proposals have in common is that they call for a limit on global warming pollution; for polluters to purchase permits at auction (or pay a tax); and for a rebate that would return the vast majority of the revenue to the American people. Such proposals are most often called cap-and-dividend or cap-and-rebate, and they “rebate” revenue back to the American people through the tax code, Social Security, other federal programs, or a direct payment.

These proposals offer distinct advantages over a policy of free permits. Like other policies, they will help the nation address the climate challenge, help clean our air, water and land, spur investment and innovation, and create jobs in clean energy technologies. In addition, these proposals would avert the windfall corporate profits from permit giveaways, send a clear market signal to reduce pollution, and create a knowable, timely and direct benefit that would leave most American households financially better off.

NO TRICKLE UP ECONOMICS

A clear advantage of an auction is that it removes the risk of windfall profits created by permit giveaways. The fundamental issue is that “free” permits

are only free to whomever they are given: they are funded in full by households through higher electricity bills, higher prices at the gas pump, and higher prices for all other products that emit carbon in their manufacture or transport. Money “trickles up” from households to Congress’s favored corporations.

Economist James Boyce, with PERI, compares the effect of free permits to that of a person inheriting a house rather than buying it. Boyce notes that simply because the owner acquired the home for free does not mean he would sell or rent it for free. Just the opposite: we expect the owner to sell or rent it at the highest market price. The same holds true for a company that happens to be given free pollution permits by government. Free allowances create corporate welfare, and disproportionately benefit the richest Americans who own the most stock.¹⁵

Timothy Geithner, Secretary of the Treasury, testified, “This program should include a 100% auction of carbon permits – ensuring that the biggest polluters don’t profit on the basis of past pollution...”¹⁶

President Obama’s Budget Director, Peter Orszag, cautioned, “If you didn’t auction the permits it would represent the largest corporate welfare program that has ever been enacted in the history of the United States.”¹⁷

Douglas Elmendorf, Director of the CBO, testified, “If companies benefited from the price increases but did not have to purchase allowances, they would receive windfall profits, which could be very large.”¹⁸

The EPA found, “Freely distributed allowances to firms tend to be very regressive.” The EPA further explained, “This is because the asset value of the allowances flows to households in the form of in-

creased stock values or capital gains, which are concentrated in higher-income households.”¹⁹

A KNOWABLE AND TIMELY BENEFIT

When any form of cap-and-trade policy begins, nearly all prices will rise as the cost of permits is absorbed into the cost of providing energy, goods and services. Household budgets will feel the squeeze in electric bills, each fill-up at the pump, and every trip to the grocery store.

Any benefit to help households pay those inevitable rising costs or invest in clean energy technologies should arrive in a timely way, monthly or quarterly, so that households have the cash they need to pay the bills. In addition, households should know exactly what their benefit is and how they get it.

In ACES, indirect benefits are buried in stocks, mutual funds, retirement accounts, electric bills and utility programs. By contrast, a direct benefit would be knowable and timely. Direct benefits could be disbursed by check, electronically through direct deposit, or through existing federal programs like Social Security.

Today, the Department of the Treasury’s Financial Management Services already disburses more than \$1.8 trillion per year to more than 100 million individuals via Social Security and veterans benefits, income tax refunds and other federal payments.²⁰ The Treasury Department directly pays Social Security to nearly 4 million individuals with no bank accounts through debit cards.²¹

These programs, and others operated at the state level, are a model for the efficient and accurate disbursement of a direct

dividend or rebate. President Obama proposed using the tax system to disburse benefits through the Making Work Pay tax credit.

Regardless of how it is administered, a household should know the amount and origin of its benefit, and have it to spend when it needs it. A benefit can be paid directly to individuals without depending on corporate middlemen and without distorting the incentive to reduce pollution and invest in clean energy.

MOST HOUSEHOLDS BETTER OFF & A STRONG PRICE SIGNAL ON CARBON

The greatest advantage of policies such as cap-and-dividend may be that they can do more to help families, especially middle-income households, and will maintain a strong price on carbon. PERI examined one scenario in which the government auctions 100 percent of the permits, at a price of \$25 per ton of carbon dioxide, sets aside 20 percent for federal climate and energy investments, and returns 80 percent of the revenue to the American people on a per capita basis. This structure was chosen in part because it follows the contours of President Obama’s budget proposal.

The PERI study shows that the median American household of four would see an annual net benefit of \$412. This is because the median household’s gross costs for energy and all other products rise by \$1,132, but its gross dividend or rebate from the permit auction is \$1,544. This policy would also generate \$30 billion in that year which can be used for other purposes, such as clean energy investments, compensating local, state and national governments for higher energy costs, or addressing regional variability.”²²

IN ACES, INDIRECT BENEFITS ARE BURIED IN STOCKS, MUTUAL FUNDS, RETIREMENT ACCOUNTS, ELECTRIC BILLS AND UTILITY PROGRAMS.

NET BENEFITS TO FAMILY OF FOUR FROM POLICY WITH 80% DIVIDENDS

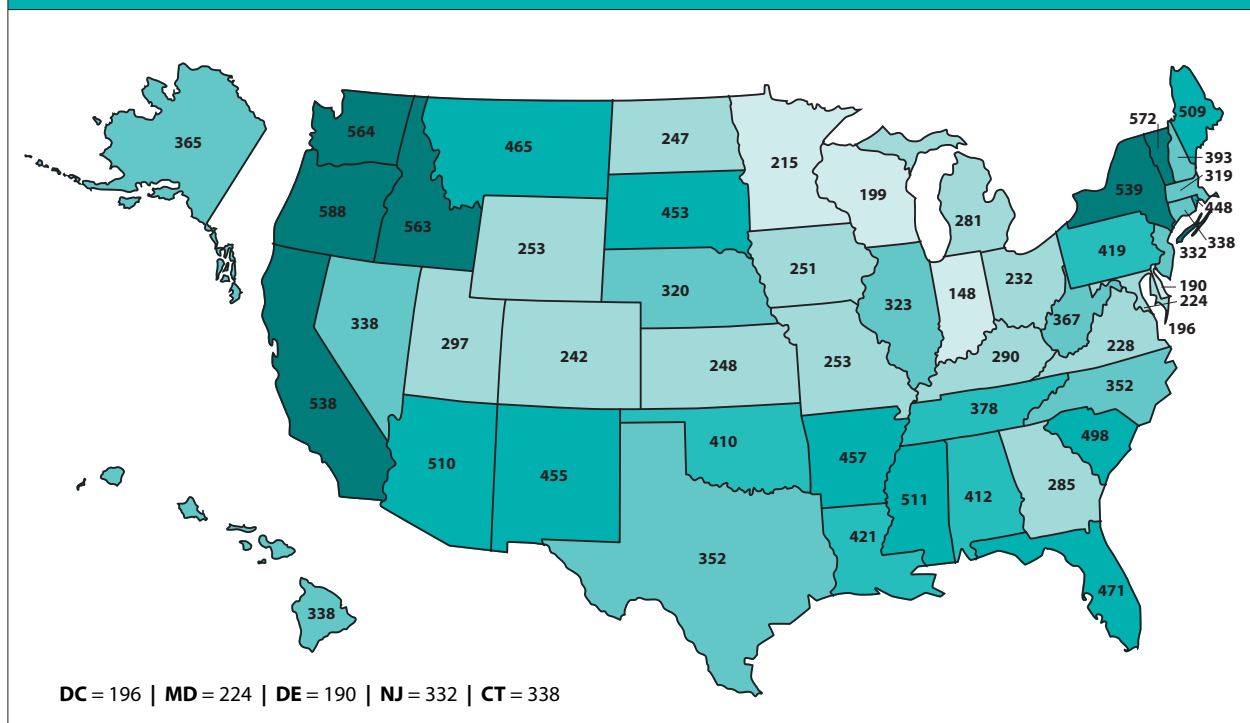


Figure 1 - SCENARIO: Net benefit to median household of four persons of a permit auction at \$25 per ton with 80% of the proceeds distributed on a per capita basis.

ADDRESSING REGIONAL VARIATION

PERI's analysis in Figure 1 demonstrates that while some policies attempt to compensate for regional pain, a policy that refunds revenue directly to households can deliver gains to most Americans in every state. However, the gains will differ somewhat between states. By combining direct payments with allocations of the revenue that vary by state, the policy could help make the benefits more evenly distributed.

The rationale for distributing auction proceeds differently among the states is that all energy policy, including the status quo, involves regional disparity. The factors that drive differences in states' carbon intensity include energy consumption and the sources of energy, including coal, natural gas and nuclear power. It matters whether a state's economy is based more in manufacturing and energy inten-

sive industries. Other factors include whether or not the state has invested in energy efficiency and the income level of its residents (wealthier households tend to consume more energy.)

PERI's Boyce and Riddle have also presented ways in which Congress can address this regional variation. They point to transitional assistance to states in the form of block grants that allow states to tailor policies to their own circumstances and priorities, and funding for environmental clean up, job training and clean energy manufacturing. Congress could also return a larger portion of the auction revenue directly to residents in states with a more carbon-intensive economy. With permits selling at \$25 per ton of carbon dioxide, more than \$30 billion would be generated from only 20 percent of the revenue for these sorts of expenditures.

**CONGRESS COULD
USE A COMBINATION
OF DIRECT BENEFITS
TO MAKE MOST
AMERICANS IN ALL 50
STATES BETTER OFF.**

In an unpublished study, Boyce and Riddle have analyzed the impacts for different states of one possible policy scenario with a combination of direct dividend assistance and transitional assistance block grants. In this scenario, 75 percent of permit auction proceeds (\$27 per ton of carbon dioxide) are allocated equally to individuals (\$380 per individual) across the nation, and 25 percent are allocated to states based on their economic and energy profile (and distributed evenly to households within each state). To determine a state's economic and energy profile, Boyce and Riddle considered a state's (1) manufacturing employment, (2) coal mining employment, and (3) carbon intensity of electricity.²³ Under this scenario, there is a dramatic shift in benefits as they flow to states typically thought to have a greater dependence on carbon. The median annual net benefit to households ranges from a low of \$61 in D.C. to a high of \$1,798 in West Virginia. The median annual benefit to households nationally is \$791. Figure 2 shows the results across the 50 states.

This analysis by Boyce and Riddle demonstrates that it is well within Congress's power to offset any regional disparities by allocating a portion of auction revenues to states as transitional assistance. The specific scenario analyzed provides more than enough money to reverse many of the regional disparities that would otherwise exist, but it provides so much money to some states that it creates new regional disparities. Congress could change the amount of money allocated to transitional assistance, as well as the rules for distributing it between states to further level the net benefits across the states. The scenario analyzed by Boyce and Riddle leaves households in states receiving transitional assistance with such large net benefits that money could be moved from

transitional assistance to other purposes while still providing net benefits to most households in all states. In other words, an appropriately designed policy could make most Americans in all 50 states better off, address regional disparities, and still

have money remaining for other purposes.

Some have argued that funneling benefits through a complex and uncertain system of corporate middlemen, as the ACES legislation does, is a means to address regional differences in energy use and protect consumers²⁴. The work by Boyce and Riddle demonstrates that it is well within Congress's power to directly benefit households and to address regional differences.

WHO PAYS MORE?

Some households would of course pay more in increased costs than they would gain from their direct benefit. As the PERI work shows, they are largely higher-income households. However, this is not because the policy simply transfers money from wealthier households to lower- and middle-income households. The amount a household pays in rising costs is based solely on their direct and indirect consumption of polluting fuels; it is not based on income. The correlation between income and higher costs exists because, on average, wealthier households consume more, but a wealthier household has more opportunity to adapt by investing in conservation, efficiency and clean technology. In addition, PERI shows that relative to income, wealthier individuals will experience a smaller percent increase in costs. The average individual with income in the top ten percent of the nation will experience a net cost increase of 0.3 percent of income at a permit price of \$25 per ton of carbon dioxide.²⁵

**NET BENEFIT TO FAMILY OF FOUR AT \$27 PER TON OF CARBON DIOXIDE,
ACCOUNTING FOR REGIONAL VARIATION**

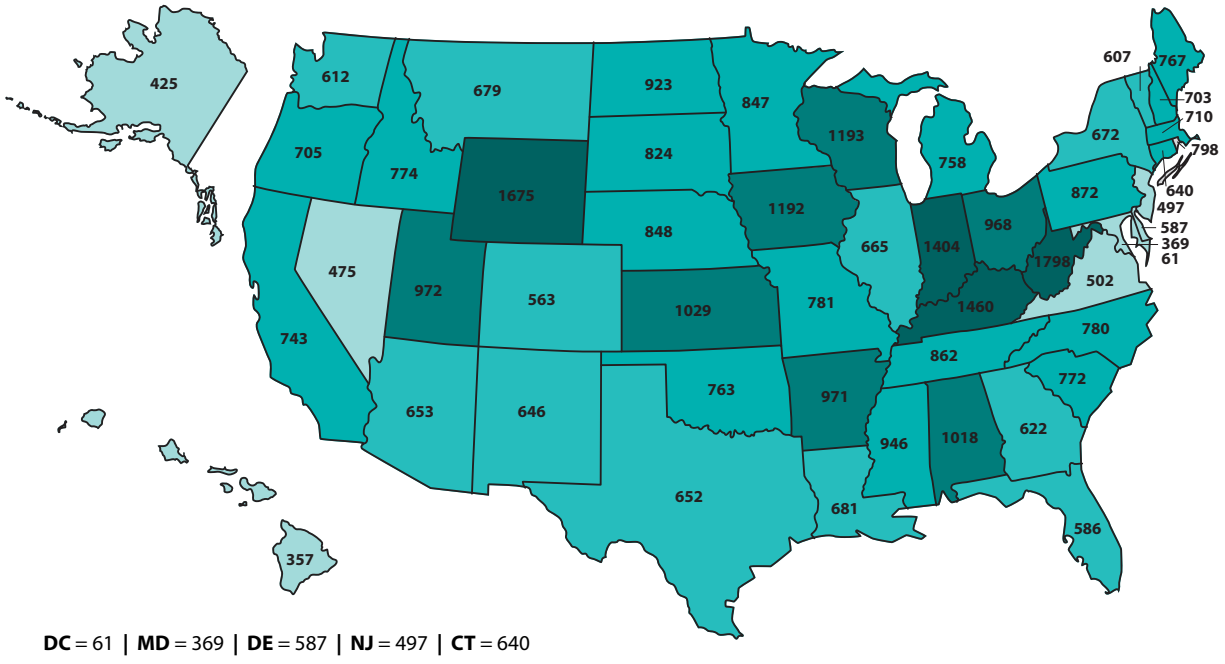


Figure 2 - SCENARIO: Net benefit to family of four at \$27 per ton of carbon dioxide with 75% of revenue in direct per capita dividend and 25% in direct per capita dividend based on coal and manufacturing employment, and carbon intensity of electricity.

CONCLUSION

The Senate does not have to acquiesce to lobbying pressure from utilities and other corporations to give out hundreds of billions of dollars in free permits. It could embrace an approach in line with President Obama's proposal and other policies that would substantially benefit lower- and middle-income families, address regional variations in energy use, and directly help households.

Even incremental reforms to ACES (such as reducing a portion of free permits earmarked to corporations and dedicating them to a direct benefit, or simply phasing out the use of free permits and increasing direct benefits far sooner than ACES would require) would substantially improve its impact on lower- and middle-income families.²⁶ ACES

A POLICY THAT CAPS CARBON, AUCTIONS POLLUTION PERMITS, AND RETURNS THE REVENUE DIRECTLY TO THE AMERICAN PEOPLE WILL MEET OUR ENVIRONMENTAL AND ECONOMIC GOALS.

eventually phases into something much closer to cap-and-dividend policy, but not until 2035 when 70 percent of permits are auctioned and most of the revenue is returned to households — but already the electric utility industry has called for an extension in the duration of free permits.²⁸

A policy that caps carbon, auctions pollution permits, and returns the revenue directly to the American people will meet our environmental and economic goals. It will limit carbon emissions and send a powerful price signal, spurring investment, innovation and job creation in clean energy technologies. It will provide a knowable, timely and direct benefit to American households, and it will leave lower- and middle-class families better off or unharmed.

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