Issue Overview:
Cap and Trade Versus Carbon Tax

On January 15, 2009, the U.S. Climate Action Partnership (USCAP) issued the *Blueprint for Legislative Action* – a detailed framework for legislation to address climate change. This brief discusses why USCAP supports a combination of cap and trade and complementary standards and policies, rather than a carbon tax. It should be considered in the context of our *Blueprint*, which includes detailed and integrated recommendations on climate protection legislation.

The overarching purpose of federal climate protection legislation is to prevent the serious harm to human health, the environment and the economy that will result from climate change. This policy objective can be accomplished only by limiting greenhouse gas (GHG) concentrations, and that requires limiting GHG emissions over time to targeted levels. To harness economic incentives, two basic options to achieve GHG reductions have been proposed: mandating a specific cap on carbon via tradable emissions allowances, or taxing carbon directly. Both approaches set a price for carbon, but cap and trade, as explained below, sets a price *and* provides environmental certainty.

USCAP supports cap and trade over a tax for the following reasons:

- **Cap and trade delivers a sure environmental outcome.** While a carbon tax controls the price of emissions, the actual quantity of emissions that will occur under a tax is less certain. Unlike a cap, a tax does not guarantee that targeted emission reductions will be achieved. Setting a tax rate in order to reduce emissions by a certain amount would involve a lot of guesswork, which would need to be updated as economic conditions change. Congress might set the initial carbon tax rate too low to reach desired emission reduction targets, a scenario that would require Congress to repeatedly raise the tax rate – a daunting task.
- **Cap-and-trade programs can readily be linked to establish a single comparable global carbon market.** Creating such linkages can reduce the cost of achieving a global environmental goal and eliminate competitive differences that would exist if the U.S. program is not linked to other trading systems. For example, USCAP recommends allowing offset credits from measurable and verifiable reductions in emissions from deforestation, which is contributing 20 percent of global GHG emissions. Such a program could integrate well with other international programs. Crediting such emission reductions under a carbon tax policy would be challenging and is likely to make the resulting carbon tax regime quite complex.
- **Cap and trade automatically adjusts to economic conditions.** Because emissions tend to decline with economic activity during a recession, allowance prices will also decline, moderating program costs. When the economy grows, allowance prices will increase due to greater demand, ensuring that growth is directed toward low-carbon investments. Congress would have to constantly adjust a carbon tax as economic conditions changed to achieve the same effect.
- **Cap and trade with cost containment narrows price uncertainty**. The USCAP *Blueprint* recommends a reserve price on auctioned allowances combined with robust but flexible limits on the amount of offsets and other mechanisms to prevent very high prices in the early years of the program. Banking and borrowing provisions minimize price volatility – another concern. These features of our recommendations significantly narrow the price uncertainty of a cap-and-trade program.
- **Cap and trade provides an effective mechanism for long-range planning.** While a carbon tax provides a high level of price certainty that facilitates long-term economic planning, cap and trade will always provide a price signal consistent with the ongoing cost of actually meeting the emission reduction targets. This certainty, along with USCAP's recommended targets and timelines and auction floor price,

will allow businesses and consumers to plan ahead and invest capital and other resources that are necessary to transform to a low-carbon economy.

- **Cap and trade delivers its environmental outcome at the lowest cost to the economy as a whole.** Cap and trade provides covered entities the flexibility to choose the lowest cost abatement method available, while guaranteeing the required emissions reductions are made. Although a carbon tax also encourages firms to employ low-cost abatement options, it does not ensure the desired environmental outcome. Moreover, cap and trade turns such least-cost alternatives into financial opportunities, transforming a negative incentive – a stick – into a positive incentive – a carrot. This combination of flexibility and positive incentives means a cap-and-trade program meets the environmental goal at the lowest cost to the economy as a whole. The Clean Air Act's successful Acid Rain Program, for example, cut pollution by 40 percent relative to 1990 levels, well ahead of schedule and at a fraction of the forecasted cost.
- **Cap and trade is not inherently more complex than a carbon tax and indeed has implementation advantages.** Either program can be designed to be simple, but both programs will require strong measures to assure broad compliance. In addition, both types of programs are likely to include features intended to address various policy goals, such as promoting new technology and addressing regional equity concerns. History suggests that Congress has difficulty enacting simple changes to the tax code. Any comparison of cap and trade to carbon tax should acknowledge that neither option is inherently more complex or simple than the other.

To learn more about the USCAP *Blueprint for Legislation Action*, please visit www.us-cap.org.