

# Environmental Watch

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## Expensive and Ineffective Cap-and-Spend Replaces Cap-and-Trade in Washington

by Todd Myers

### Claim

“In 2007, the CAT called for Washington to ‘build market-based mechanisms to unleash investment in the creativity and innovation of Washington’s economy to deliver cost-effective emission reductions.’ ”

*Washington State Climate Action Team, “Leading the Way: Implementing Practical Solutions to the Climate Change Challenge,” November 2008, [http://www.ecy.wa.gov/climatechange/2008CATdocs/ltw\\_app\\_v2.pdf](http://www.ecy.wa.gov/climatechange/2008CATdocs/ltw_app_v2.pdf)*

“This effort implements the cap on climate pollution the Legislature adopted last year. Emitters would pay for pollution permits, and the new revenue would be invested to reduce fossil fuel dependence, create green jobs and spur new clean-tech innovation, while providing assistance to moderate- and low-income households struggling with high energy costs.”

*Environmental Priorities Coalition, “Cap and Invest,” <http://www.environmentalpriorities.org/cap-and-invest> (Accessed December 18, 2008)*

### Facts

For two years, the Washington State Climate Advisory Team (which became the Climate Action Team in 2008), has emphasized the role of “market-based” tools to reduce carbon emissions. The cap-and-trade system has a long pedigree, emerging in the 1990s to reduce sulfur dioxide and acid rain. Unlike traditional environmental mandates, companies were allowed to trade emissions allocations, ensuring that companies who could reduce emissions most cheaply had an incentive to do so and could profit from that reduction.

Now, environmental activists in Washington have abandoned the pretense of supporting market-based approaches, instead using the system to give government billions in new spending authority while relying on politicians to set the direction of our economy. Indeed the head of the effort for the cap-and-spend approach even talked about using climate change to “remake the economy of the nation, the entire globe.”<sup>1</sup>

This approach is unwise for many reasons, including the massive cost to prosperity and jobs. Ironically, this approach, while it comes with a high cost, will ultimately fail even to achieve the goals set by the environmental activists for the same reasons that even more flexible approaches failed in Europe under Kyoto.

### Cap-and-Spend vs. Cap-and-Trade

Cap-and-trade is called “market-based” only because it creates a commodity, greenhouse gases, and allows emitters to trade that commodity in a market like any other commodity. Carbon credits are either allocated freely based on historical emissions, as offered recently by Governor

<sup>1</sup> Lisa Stiffler and McGann, Chris, “Bill orders firm steps to make state ‘greener’ ,” Seattle Post-Intelligencer, February 19, 2008, [http://seattlepi.nwsourc.com/local/351926\\_climate20.html](http://seattlepi.nwsourc.com/local/351926_climate20.html) (Accessed December 22, 2008)



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Gregoire, or auctioned. In an auction, the state arbitrarily sets an overall cap of emissions allowed in the state, then auctions credits up to that cap. Companies would need to buy credits for every ton of CO<sub>2</sub> (or other greenhouse gases) they emit. The cost of these credits would then be passed on to consumers. Under an auction system the state would end up with huge amounts of revenue equivalent to a massive tax increase on the economy. This could amount to hundreds of millions of dollars. The question is, what should politicians do with this money?

There are two strategies. The first is to rebate this money to taxpayers in a variety of ways. This would make the system revenue neutral or nearly so. The second alternative is to use this money as a political tool to fund favored projects and interest groups. The environmental activists have chosen the latter.

They offer a laundry list of proposals for ways to spend the money including funding “investment” in green energy, funding research and helping pay for energy costs. This strategy not only would do serious damage to the economy, it would ultimately collapse, and would encourage emitters to avoid the limits

First, the environmentalist admit that this cap-and-spend strategy would create “high energy costs.” The key reason is that a relatively small percentage of Washington’s greenhouse gas emissions come from energy. Thus, to reduce GHG effectively, there would need to be significant reductions in energy-sector emissions, leading to a dramatic increase in costs for consumers.

Worse, the system would be extremely inflexible. Washington enjoys a high level of CO<sub>2</sub>-free energy sources, like hydro and nuclear. However, in low-water years, we would have to replace carbon-free hydro energy with carbon-based energy from states like California and Montana. Thus, Washington’s carbon emissions could fluctuate dramatically from year-to-year. A rigid cap would cause dramatic price shocks for families and businesses.

Such uncertainty is likely to have a number of results, most importantly, it would cause businesses to avoid Washington state or relocate out of the state. When Washington dealt with the energy crisis of the summer of 2001, aluminum companies, who rely on significant amounts of energy, shut down. Under an auction system, Washington could see that level of price volatility on a fairly regular basis. What’s more, under the cap-and-trade rules being established by the Western Climate Initiative, each state can choose whether to allocate carbon credits freely or auction them. Thus, Oregon could allocate free credits, creating more price certainty for energy users. This would create a strong incentive for businesses to leave states with energy uncertainty, like Washington, and shift economic growth to states that choose a more business-friendly approach. This is a certain job-killer for states that follow the environmental activists’ approach.

Finally, leakage could also undermine the effort to reduce CO<sub>2</sub>. Carbon emissions are not like air pollution, where the problem is local. A ton of CO<sub>2</sub> emitted anywhere affects everyone. Thus, simply moving CO<sub>2</sub> emitters out of Washington has no effect on climate change. Europe was well aware of this problem when it allocated carbon credits. A recent report by the Government Accountability Office notes that European governments allocated extra free credits to certain industries because, “there were concerns that compliance with the ETS would create costs for covered entities that compete with facilities outside the EU that are not subject to carbon limits.”<sup>2</sup> If carbon emitting industries simply leave Washington for other states or countries, we will not only have outsourced jobs and prosperity, but have done little to cut CO<sub>2</sub> emissions.

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<sup>2</sup> U.S. Government Accountability Office, “INTERNATIONAL CLIMATE CHANGE PROGRAMS Lessons Learned from the European Union’s Emissions Trading Scheme and the Kyoto Protocol’s Clean Development Mechanism,” November 2008, <http://www.gao.gov/new.items/d09151.pdf> (Accessed December 18, 2008), p. 15

Ironically, the state measures only total carbon emissions meaning that when companies shut down or move, it will actually be interpreted as progress toward reducing emissions. The CAT's incentives will actually encourage businesses to shut down or move. The reductions that result from business closures will be used to argue not that the system is failing, but that it is working!

Another problem with the cap-and-spend approach being offered is that it puts most of its eggs in the basket of hoping legislators correctly pick and choose the technologies most likely to reduce CO2 emissions in the future, and can do so better than experts and those who risk their own money. Their record on this score is atrocious. In the last few years legislators have pushed subsidies for biofuels only to see them drive food prices up. They mandated "green" buildings that have failed to achieve the predicted energy savings. They promoted light rail, despite Sound Transit's data indicating that it would reduce CO2 emissions by less than 1 percent compared to doing nothing. And, California mandated zero-emissions vehicles for nearly two decades, before capitulating this year and allowing hybrids, which emerged not from government programs but from the free market.

Rewarding that poor record, environmental activists would give the legislature many millions, perhaps billions, more. Before environmentalists justify this increased level of funding and responsibility for politicians, they should at least offer some success stories of government making sound economic decisions. They are few and far between.

## **Costs**

Environmental activists' cap-and-spend approach to reducing greenhouse gases creates the worst of both worlds: it destroys jobs and prosperity and is likely to fall far short of meeting the greenhouse gas reduction targets. The fundamental problem is it moves away from a market-based system back to a hard cap system where all of the cost is borne by emitters, with little flexibility to reduce costs and adjust to uncertainty.

The key to improving energy efficiency, reducing the risk from CO2 and encouraging economic and technical growth, is to offer a clear, simple policy that encourages individuals to take responsibility for environmental and economic sustainability.