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SENATE CAN STRENGTHEN CLIMATE LEGISLATION BY REDUCING CORPORATE WELFARE AND BOOSTING TRUE CONSUMER RELIEF

CBO Finds Middle-Income Households Would Fare Less Well than High-Income Households Under House Bill, Due to Certain Business Provisions

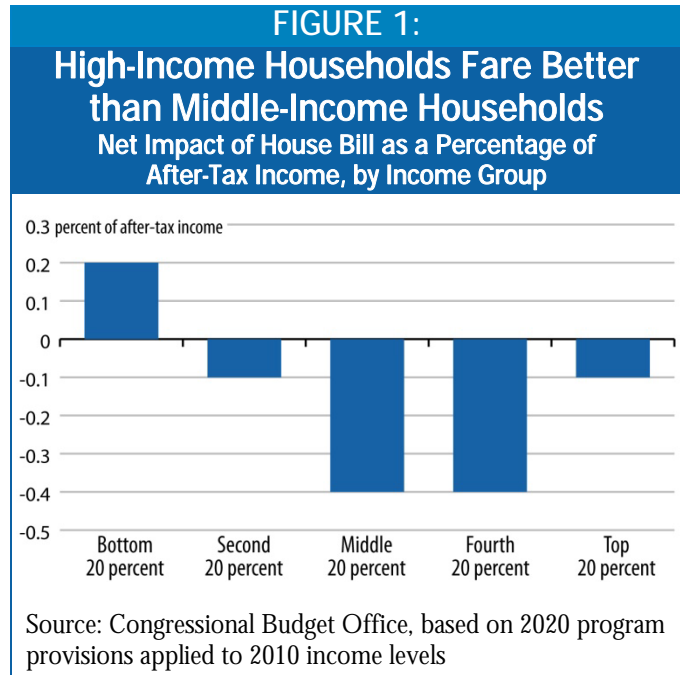
By Chad Stone and Hannah Shaw

Executive Summary

The House's June 26 passage of the American Clean Energy and Security Act represents a milestone in climate policy, moving the nation closer to enacting legislation that combats global warming while mitigating the burden of higher energy costs on the most vulnerable households. The Senate can improve on this legislation, however, by redressing the imbalance that remains between provisions in the bill that largely favor businesses and their high-income shareholders — and effectively represent corporate welfare — and provisions that truly provide relief to typical households.

- **A substantial share of the resources going to utilities to provide their customers relief from higher energy prices would instead go to business profits.** To deliver consumer relief, the House bill relies heavily on free allocations of emissions allowances to electricity and natural gas utility companies; the utilities are directed to use these resources to keep down their customers' bills. But over 60 percent of the relief the bill would distribute through utilities would go to utilities' business customers, not individual households. A Congressional Budget Office (CBO) analysis concludes that businesses would retain this relief as added profit rather than pass it on to their customers in the form of lower prices for their products.
- **The profits from lower utility bills for businesses would primarily benefit the high-income households who own or hold stock in the firms.** About 63 percent of the allowance value given to utilities to benefit their business customers would ultimately go to the highest-income 20 percent of households, according to CBO.
- **As a result, upper-income families would fare better than middle-income families under the House bill.** Taking into account both the higher energy costs that consumers would face and the consumer relief the bill would provide, CBO finds that middle-income households would face a larger net hit on their budgets (when measured as a share of their income) than households at the top of the income scale would, though the hit in both cases would be modest (Figure 1). This is because households at the top would reap most of the benefits from the increased business profits flowing from the utility relief.

- **Delivering consumer relief through utility bills could also undermine incentives to conserve energy and invest in energy efficiency**, because this relief may cause people to believe that home energy prices have not increased much.
- **A better alternative is to expand direct relief to consumers.** The Senate could improve the House bill by scaling back the large sums it gives to utility companies to provide benefits to businesses and using the funds instead to strengthen consumer relief for moderate- and middle-income households through a mechanism such as a refundable tax credit, as well as for other environmental purposes.



Upper-Income Households Would Fare Better Than Middle-Income Households Under Bill

The House legislation (H.R. 2454) uses a “cap-and-trade” mechanism to reduce emissions. The bill would place a cap on total fossil-fuel emissions, which would tighten over time. Electricity generators and other emitters of greenhouse gases would need a permit (or “allowance”) for each ton of carbon they emit; as the cap tightened, the number of allowances would shrink. The requirement to hold allowances would constitute a business cost that, for the most part, firms would pass on to consumers, leading to higher prices for energy and energy-related goods and services.

These higher prices would provide an important incentive for businesses and households to conserve energy and make cost-effective investments in energy efficiency and alternative clean energy technologies. But they would also impose a hit on consumers’ budgets. To mitigate this hit, other provisions in the bill would provide financial relief to consumers and businesses. The *net* impact on households’ budgets would be the difference between the costs they would incur due to the emissions cap and the financial relief they would receive.

The Congressional Budget Office has analyzed the bill’s impact on the average household in each fifth (or “quintile”) of the income distribution.¹ Specifically, CBO has estimated how the major

¹ Congressional Budget Office, “The Estimated Costs to Households from the Cap-and-Trade Provisions of H.R. 2454,” June 19, 2009. CBO analyzed the bill as reported by the House Committee on Energy and Commerce. The bill that passed the House on June 26, H.R. 2454, was a slightly modified version of the bill that CBO analyzed. Thus, the numbers in this analysis differ slightly from what they would be if based on the bill as passed. The allocation of allowances reflected in the CBO distributional analysis is broadly consistent with the allocation of allowances during the 2016 through 2025 period when free allocations to utilities would be fully phased in and before they would start to be phased out.

provisions of the legislation that would be in place in 2020 would affect households in different quintiles if these provisions were in effect in 2010 (see Figure 2).

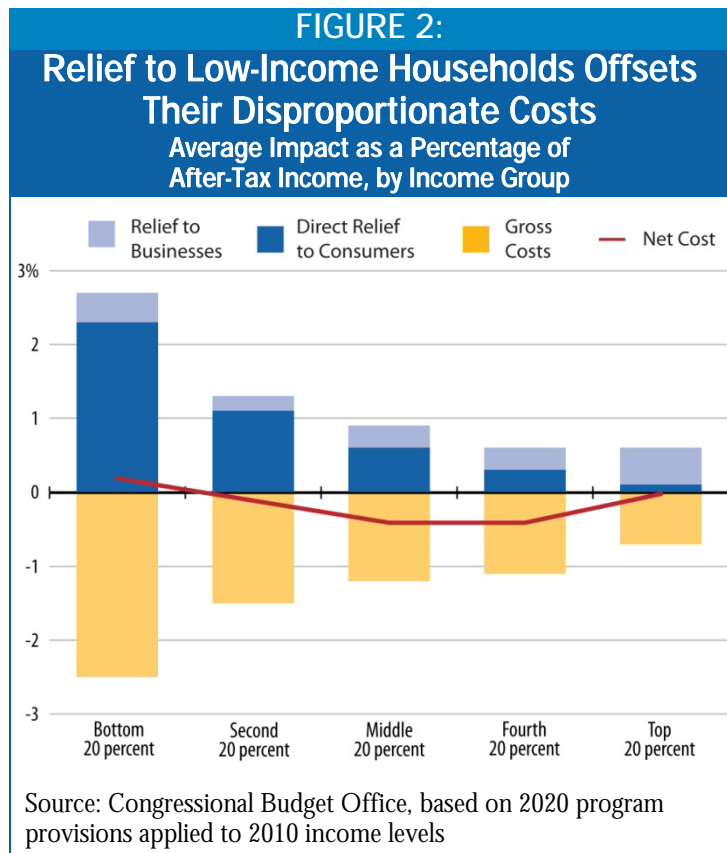
The CBO analysis confirms that the bill provides significant protection to low-income households. Measured as a share of after-tax income, both the costs incurred and the financial benefits received would be largest for the bottom quintile. Put another way, low-income consumers — who are the least able to adjust to higher energy prices by purchasing new, more energy-efficient vehicles or appliances — would bear the largest burden in the *absence* of consumer relief but would benefit the most from the relief that the legislation provides. The average household in the bottom quintile would incur no net financial loss under the legislation.

The analysis also shows, however, that for moderate-income households a little further up the income scale and for middle-income households, the increase in energy costs would exceed the consumer relief provided.

In fact, CBO found that the legislation would generate a larger net loss, as a percentage of income, for households in the middle of the income scale than for those at the top, although the losses for both groups would be rather modest. When measured as a share of income, the energy-related cost increases would be smallest for the highest-income households, and while these households' direct consumer relief would be relatively small as a share of their income, they also would receive substantial financial benefits from the relief provided to *businesses*. That relief would translate into larger business profits and hence increases in shareholder income, which would accrue disproportionately to people at high income levels.

Bulk of Emissions Allowances Aimed at Businesses Would Ultimately Benefit Highest-Income Households

From a purely economic standpoint, the most cost-effective cap-and-trade system would be one in which the government auctions all of the emissions allowances and specifies through legislation how the proceeds are to be used to meet various public purposes. These would include providing consumer relief, encouraging investments in energy efficiency and alternative clean energy technologies, and providing transition assistance to the workers, businesses, and communities most likely to be adversely affected by the economic restructuring that will occur as emissions are reduced.



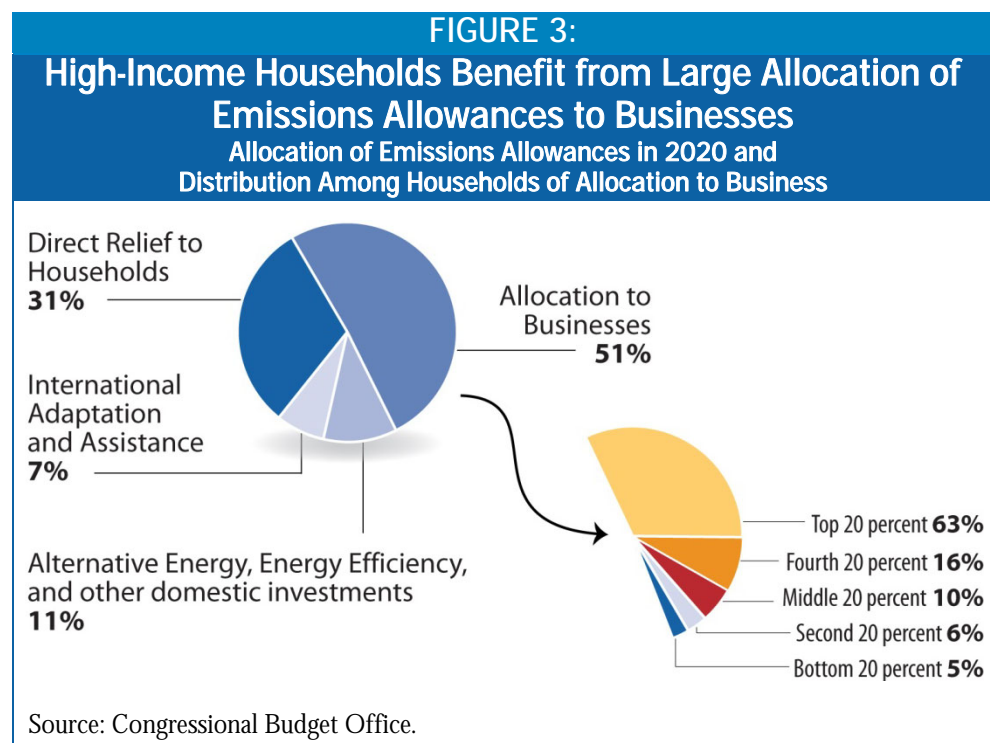
The House bill charts a different course. It auctions only a small percentage of allowances over the 2012-2025 period — mostly to pay for direct refund payments to low-income consumers — and relies on free allocations of allowances to achieve its other purposes.

Some commentators have criticized the legislation for giving away too large a percentage of emissions allowances (83 percent in 2020 in the version of the legislation that CBO analyzed²); these critics implicitly assume that auctioned allowances are in the public interest but freely allocated allowances are not. Other commentators have defended the free allocations, arguing that a large percentage of these allocations support public purposes, including consumer relief.

To sort out these claims, it is necessary to look beyond whether allowances are auctioned or given away, who initially receives the free allowances, and the ostensible purpose of those allowances — and to ascertain who would end up benefitting and how much (see the box on page 5). This is what CBO has done.

CBO found that in 2020 under the House bill, about 31 percent of the total allowance value would go to households, either as direct payments to low-income households or as relief on household utility bills that local utility companies would provide to households at all income levels.

In contrast, about 51 percent of the allowance value would go to businesses, where it would mainly increase profits.³ And since profits ultimately result in income to owners and shareholders, who tend to have high incomes, CBO found that about 63 percent of the allowance value given to businesses would end up benefiting households in the highest income quintile. (See Figure 3.)



² Differences between these proportions and those under the bill that the House ultimately approved are minor.

³ The remaining 18 percent of allowances would go to federal and state governments. About 11 percent would be used for energy efficiency and clean energy technologies, other public purposes, and deficit reduction. The other 7 percent would be spent overseas to prevent deforestation, encourage the adoption of more energy-efficient technologies, and help developing countries adapt to climate change.

Addressing Misconceptions in Debates Over Allowances

In thinking about the auctioning of allowances and the free distribution of allowances, it is useful to keep four points in mind.

- The amount of emissions reduction under a cap-and-trade system is largely unaffected by whether the government auctions the emissions allowances or gives them away, since the level at which Congress sets the emissions cap would be the same in either case.
- Giving away emissions allowances to electricity generators and other entities that are required to hold allowances (rather than requiring them to purchase the allowances) does not change those businesses' pricing and production decisions. That is because capping emissions effectively limits the *supply* of fossil-fuel energy — and thereby causes the price that producers can charge for energy to increase, since prices will have to rise to the point that the *demand* for fossil-fuel energy falls to match the supply. This price increase, rooted in the basic laws of supply and demand, will occur regardless of whether firms have to purchase emissions allowances or receive them for free.
- As a result, giving energy producers free allowances with no restrictions on their use increases those companies' profits: they get to charge the higher market prices for energy and energy-related products *without* having to buy the allowances responsible for those higher prices. As a number of analysts (such as Greg Mankiw, chair of President George W. Bush's Council of Economic Advisers) have noted, such giveaways of free allowances to energy producers essentially constitute "corporate welfare." CBO has similarly written that such free allowances would result in companies receiving "windfall profits."^a
- The situation is more complicated for the large percentage of free allowances that the House bill would provide to regulated local electric and gas utilities. In this case, as explained in the body of this paper, some benefits would flow directly to consumers, while others would accrue to businesses and increase their profits.
- Congress can designate some free allowances for public purposes, such as encouraging investments in clean energy technology research and development, energy efficiency, and training prospective workers for "green jobs." In this case, the issue of whether Congress provides these allowances for free and requires recipients to use them for the specified purpose or auctions them and authorizes the use of the proceeds for that purpose is much less important than whether the mechanisms used to achieve the public purpose are effective and efficient.

^a See Greg Mankiw, "Greg Mankiw's Blog: Random Observations for Students of Economics," August 2, 2007; Statement of Peter R. Orszag, Director of the Congressional Budget Office, "Approaches to Reducing Carbon Dioxide Emissions," before the Committee on the Budget, U.S. House of Representatives, November 1, 2007.

CBO Findings Illustrate Shortcomings of Utility-Based Approach

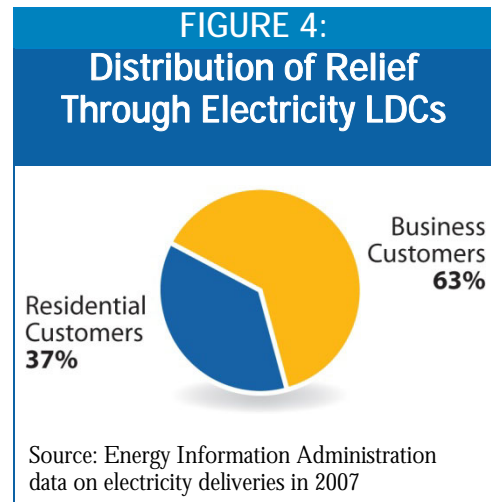
CBO reported that under the House legislation, nearly half (45.5 percent) of the allowances in 2020 would be given to local utility companies (known as local distribution companies, or LDCs) that serve residential and business customers.⁴ The legislation directs the local electric and gas

⁴ CBO includes in this broad "LDC" category a small fraction of allowance value that would go to states to be used for the benefit of consumers of heating oil, propane, and kerosene for residential or commercial purposes and a modest (5 percent or less) percentage of allowances that would go to "merchant coal" generators, which are unregulated competitive generators of electricity. The distributional effects of the allocation to the states are akin to those of the

utilities to use these allowances “exclusively for the benefit of retail ratepayers.” LDCs receiving free allowances would, for the most part, sell them, use the proceeds to offset the higher prices they would pay for wholesale electricity, and pass the savings on to their customers.⁵

The legislation relies on state public utility regulators to oversee what the utility companies actually do with these allowances. Some utilities in states where the regulatory boards are weak might be able to increase their profits to a degree. But where regulators do their job, or the legislation is strengthened to require more accountability by LDCs on this matter, the LDCs’ customers should be the main beneficiaries of the free allocations to the LDCs.

The bill also requires that LDCs divide the benefits of the free allowances they receive between their residential and business customers in proportion to the electricity and natural gas deliveries they make to these two groups. Since LDCs’ business customers account for over 60 percent of electricity and natural gas deliveries, they would receive the lion’s share of the benefits (see Figure 4).⁶



Businesses Unlikely to Pass Benefits Received From LDCs on to Consumers

This leads to the question of how businesses would respond to the benefits they receive through actions by LDCs to hold down their utility bills. CBO has concluded that these benefits would go into businesses’ bottom lines, with the increased profits boosting incomes for owners and shareholders rather than being passed on to the firms’ customers.

This conclusion stems from a related provision of the bill. The legislation states that when LDCs pass the benefits of their free allowances on to their customers in the form of a rebate or other reduction in customers’ bills, the rebate or reduction should be provided to the maximum extent practicable on the *fixed portion* of the bill, rather than being based on the quantity of electricity or natural gas the customer uses. In principle the fixed portion of the bill covers the costs of the wires and other infrastructure that have to be in place regardless of how much electricity or gas is

allocation to electricity and natural gas LDCs, but the allocation to merchant coal generators — who face no restrictions on how they may use these funds — will mainly benefit the shareholders of the companies receiving the allocation. The bill that the House passed also designates a small percentage of the allowance value for generators with long-term delivery contracts (which would have distributional effects like those for allocations to merchant coal generators) and adds a small fraction of allowance value for “small LDCs,” typically rural electric co-ops. The allocations to small LDCs would have distributional effects similar to those for other LDCs.

⁵ The provisions of the bill relating to natural gas and home heating oil require that a specific portion of the benefit be delivered through energy efficiency programs for consumers. The bill is silent on the role of energy efficiency programs for electricity customers.

⁶ According to the latest data from the Energy Information Administration, 37 percent of electricity retail sales are to residential customers and 63 percent are to business customers. About 30 percent of natural gas retail sales are to residential customers and about 69 percent are to business customers.

delivered, as well as billing and other administrative costs; the variable portion of the bill reflects the cost of the energy itself and other costs that vary with the quantity of energy the customer uses.

The House included this provision in an effort to prevent the LDC relief from undercutting the legislation's goal of encouraging people to use less fossil-fuel energy. If customers see on the variable portion of their bills that the rate they are charged for each kilowatt hour of electricity has increased significantly, they have an incentive to conserve energy and invest in energy efficiency — even if their overall utility costs have not risen much because of the reduction in the fixed portion of their bills.

But it is a basic proposition in economics, which is reflected in the CBO analysis, that firms alter their pricing and production decisions when costs that vary with how much they produce change but do *not* alter these decisions when fixed costs (which do not vary with how much they produce) change.⁷ Thus, if firms receive a reduction in the fixed portion of their bills, they will keep it as profit. In contrast, if they incur an increase in the variable part of their bills, they will have an incentive to offset those added costs by charging their customers more. When firms simultaneously receive a reduction in the fixed part of their bills and an increase in the variable part, as intended in the House bill, they generally will retain the reduction in fixed costs as profit and try to pass on the increase in variable costs.

Following this economic logic, CBO estimates that the allowance value given to LDCs and earmarked for their business customers will *not* end up being passed through to households.⁸ Instead, it will increase those business customers' profits. CBO has concluded that this increase in profits will primarily benefit the high-income households who own or hold stock in these firms.

As a result, under CBO's estimates, the distribution of benefits from the bill's large allocations of allowances to LDCs would be highly regressive. As noted above, CBO estimates that about 63 percent of the allowance value given to LDCs to benefit their business customers would ultimately go to households in the top income quintile.

⁷ A firm is maximizing its profits when any increase in how much it produces would increase its costs by more than it would increase its revenue and any decrease in how much it produces would reduce its revenue by more than it would reduce its costs). A change in fixed costs does not change this decision because it does not change the relationship between incremental revenues and costs. A change in variable costs does change that relationship and hence the firm's profit-maximizing behavior.

⁸ The bill reported by the House Energy and Commerce Committee, which is the bill that CBO analyzed, is clear in its intention that LDCs apply rebates to the fixed portion of the bill for all ratepayers to the maximum extent practicable. Language was added to the bill that passed the House floor which creates some ambiguity about the treatment of industrial customers. The language says rebates *may* vary with the quantity of electricity delivered. If that is interpreted to mean that each industrial customer gets a rebate based on how much electricity it uses, that would be the equivalent of allowing utilities to apply the relief provided to industrial customers on the variable part of the bill and would undercut the goal of the legislation, which is to create incentives to reduce carbon consumption. A different interpretation is that the change merely reflected the recognition of huge size disparities among industrial users. If several size classes were created but the rebate was uniform for all firms in the same size class, the intention of the bill to provide a rebate on the fixed portion rather than the variable portion of the bill would be preserved. This is just one of the many complex issues that state utility regulators will confront in trying to implement a utility-based approach to mitigating the impact of higher energy costs on households' budgets.

Channeling Relief Through LDCs Raises Other Concerns

The allocations to LDCs for their *residential* customers pose a somewhat different set of issues. Earlier Center on Budget and Policy Priorities analyses have identified a number of problems with using LDCs to deliver consumer relief.⁹ The LDC approach provides households no relief from the majority of the increase in costs they will face under an emissions cap because more than half of that increase will arise from sources *other than* home utility bills, such as higher prices for gasoline and a wide array of goods and services produced or transported by fossil fuels. In addition, state regulation of LDCs tends to be uneven across states, raising questions about the extent to which allowances given free to LDCs would provide well-targeted and effective consumer relief in all jurisdictions.

Perhaps the most troubling issue relates to the effects of the LDC approach on the costs of other forms of energy and energy-related products. To the extent that holding down increases in residential customers' utility bills lessens their incentive to conserve home energy and make energy efficiency improvements, this approach would lead to even higher increases in prices for *other* energy-related products. Since there would be less of a decrease in emissions from home energy use, emissions reductions from other sectors would have to fall even more to comply with the overall cap on emissions; that would raise the price of emissions allowances and the cost of meeting the cap, which is why the prices of goods and services other than home energy would increase more.

As noted, the House bill attempts to address this problem by directing LDCs to provide relief to their customers through the fixed part of consumers' utility bills, rather than reduce the amount that consumers pay for their actual electricity use. CBO assumes that business users will understand this distinction and respond to the "price signal" accordingly.

But it is much less likely that households will scrutinize their utility bills in such detail. If households' overall utility costs do not rise much, they are not likely to examine the fixed and variable parts of their bills and thereby understand that regardless of the rebate they have received, they are paying a significantly higher rate on the power they use and thus would benefit from conserving energy or investing in energy efficiency. And in the absence of "sticker shock" in their utility costs, households are much less likely to change their behavior regarding electricity and natural gas use.

Experts on the economics of the electricity sector at Resources for the Future, the nation's foremost think tank on environmental economics, have explained why households receiving relief through LDCs are unlikely to reduce their electricity use:

How customers might react depends on two important considerations. First, the degree to which fixed charges are separated from variable charges varies around the country, but the dominant practice in most jurisdictions places little of the fixed cost in a fixed charge. ... Second, even if LDCs were to separate these components and efficiently display in customer bills the allocation of allowance value as a reduction in the fixed charge, the outcome depends on whether customers respond rationally to the price signal at the margin. Industrial and commercial class customers may be

⁹ See Chad Stone, "Holding Down Increases in Utility Bills Is a Flawed Way to Protect Consumers While Fighting Global Warming," Center on Budget and Policy Priorities, June 3, 2009.

more likely to respond in this way. Nonetheless, myriad recent studies highlight departures from rational behavior in energy consumption, and the prospect that customers would appreciate the distinction between their bill and the variable cost is speculative, especially for residential class customers.¹⁰

Resources for the Future looked at two scenarios for how LDC customers would respond if the utility relief on their bills is provided as the House bill directs. In one scenario, LDCs are able to properly separate fixed and variable charges on their customers' bills and business customers respond rationally to the separation, recognizing that their variable costs have gone up while their fixed costs have gone down. In the other scenario, the distinction between fixed and variable charges is vague on customers' bills and businesses mainly respond to the bottom line— i.e., how much they owe — rather than discerning and responding to the different treatment of the fixed and variable portions of their bills. Under both scenarios, RFF assumes that *residential* customers would largely look at and respond only to their bills' bottom line.

In the scenario in which businesses recognize the separation between fixed and variable charges (the outcome that CBO's recent analysis assumes), RFF found that the LDC approach to providing relief would still have substantial adverse effects. Since residential customers would not grasp or act on the distinction between the fixed and variable charges, the LDC relief would lessen households' incentives to conserve energy. RFF estimated that using 30 percent of the emissions value for LDC relief — rather than auctioning an equivalent amount and returning the proceeds to consumers on a per-capita basis — would substantially increase the price of the emissions allowances and hike consumers' costs for energy products other than home utilities; the average cost per household of meeting the emissions cap would be 51 percent higher. (RFF also noted that the overall distributional effects of the LDC relief would be highly regressive, because businesses would not pass on to their customers the relief they received through the LDCs.)

Under RFF's second scenario, in which *both* businesses and households fail to perceive and respond to the "price signal" in their bills that should encourage them to change their energy consumption behavior, the average cost per household of meeting the emissions cap would be greater still. On the other hand, the distributional impact would be less regressive in this case because businesses would pass through the LDC relief they received.

The Dilemma with the LDC Approach: Either Corporate Welfare or Higher Energy Costs

RFF's analysis shows that seeking to benefit consumers by giving emissions allowances free to LDCs to keep down their customers' bills puts policymakers on the horns of a dilemma. If they structure the LDC relief for businesses so it focuses on the fixed part of firms' utility bills as the House bill analyzed by CBO does, they will essentially be providing windfall profits — or corporate welfare — on a wide scale, with highly regressive results. If, instead, they try to require LDCs to provide relief on the variable portion of the bill (or if businesses respond only to their bottom-line utility costs), they will be blunting the incentive to reduce consumption, thereby causing prices for

¹⁰ Rich Sweeney, Josh Blonz and Dallas Burtraw, "The Effects on Households of Allocation to Electricity Local Distribution Companies," Resources for the Future, June 5, 2009, http://www.rff.org/wv/Documents/LDC_Allocation_090605.pdf.

other energy-related products to climb further and raising the economic costs of combating global warming.¹¹

A better alternative exists. The Senate would be well-advised to scale back the LDC portion of the House bill — especially the large amount of the LDC relief earmarked for commercial and industrial users — and to devote the freed-up funds to direct consumer relief for moderate- and middle-income households to supplement the relief that the bill provides to low-income households. The next section discusses this approach.

Expanding Direct Benefits to Consumers

Providing direct relief to consumers — through the tax system and existing benefit delivery systems — has a number of advantages over free allocations to LDCs.¹² The assistance can be targeted to offset the impact of higher energy-related prices on low- and moderate-income households (who are most vulnerable to these price increases) and on middle-income households, who also will feel the squeeze. Such relief can offset the increases in households' energy-related expenses for the full array of items affected by curbs on greenhouse gas emissions, not just the increases in their utility bills. And unlike free allocations to LDCs, direct relief would not force policymakers to decide between providing businesses with windfall profits and making it more expensive for both consumers and the economy as a whole to achieve the benefits of climate change legislation.

Direct relief would cushion households from the loss in purchasing power that would result from higher energy prices while preserving their incentives to conserve energy and invest in energy efficiency improvements. Because energy-related products would cost more, households that can conserve energy or invest in energy efficiency would get greater value for their budget dollar by taking those steps than by using their refund to maintain old ways of consumption. At the same time, direct consumer refunds would help vulnerable households that cannot easily reduce their energy consumption to avoid a reduction in their standard of living. In short, direct consumer relief preserves the “price signal” that creates the incentives which drive the effectiveness of a cap-and-trade system without creating windfall profits that result in regressive effects on household income.

¹¹ RFF's analysis does not incorporate all of the features of the House bill, which include cost-containment measures that could hold down the costs that would arise from the blunting of price incentives. In particular, analyses by CBO, the Environmental Protection Agency, and the Energy Information Administration all find that in the early years of climate legislation, firms would “bank” allowances to be used later when the costs of compliance are expected to be higher because the cap is tighter. Upward pressure on near-term allowance prices of the sort described by RFF could lead to less banking, in effect shifting the costs into the future. In addition, the House bill allows extensive use of international offsets, which allow firms to meet their compliance obligation under the cap not by reducing their own emissions but by in effect purchasing emissions reductions abroad. Upward pressure on allowance prices would increase the demand for international offsets. If such offsets were readily available, their use would mitigate some of the upward pressure on allowance prices and costs.

¹² For a description of a specific proposal to provide direct consumer relief to both low- and middle-income households, see Sharon Parrott, Dottie Rosenbaum, and Chad Stone, “How to Use Existing Tax and Benefit Systems to Offset Consumers' Higher Energy Costs Under an Emissions Cap,” Center on Budget and Policy Priorities, April 20, 2009.

The House bill does include some direct relief to households. It uses 15 percent of the emissions-allowance value each year to fund an energy refund for low-income households.¹³ CBO estimates that this refund, together with the relief on utility bills that households would receive from the LDC provisions for residential consumers, would keep low-income households as a group from being made worse off.

Most other households would only receive relief through their utility bills, and since (as noted) combating global warming will impose costs that go beyond higher utility bills, CBO estimates that most households' benefits would fall short of their extra costs. For households overall, the annual net loss (by 2020) would be \$165 per household, in today's dollars.¹⁴ For households in the middle fifth of the income scale, the loss would be \$235 per household.¹⁵

These are not particularly large amounts, especially for landmark legislation that would begin to address the potentially catastrophic impacts of climate change. Yet policymakers could reduce these modest costs substantially by shifting some resources from free allocations for LDCs, especially for the LDCs' commercial and industrial customers, to well-crafted direct consumer relief. A portion of the resources freed up from reducing allocations to the LDCs also could be used for other environmental purposes.

In an earlier analysis, the Center on Budget and Policy Priorities identified a mechanism for extending direct consumer relief to low- and middle-income families that combined a refundable tax credit and direct payments to seniors and veterans with the electronic benefit transfer (EBT) mechanism for low-income households that is already a feature of the House bill.¹⁶ Policymakers would need to decide how large a direct payment they would like to provide and how far up the income scale they wish to provide it, based on the funding available for such relief.

The Center also recommends using roughly 1 percent of the allowance value each year to fund an increase in the Low-Income Home Energy Assistance Program (LIHEAP). More funding for LIHEAP would help those low-income households for which the increase in energy costs under the bill would be significantly higher than average — because they live in older, poorly insulated houses or have older, less energy-efficient appliances — and would exceed the relief they would receive under the House bill.¹⁷

¹³ For details see Dorothy Rosenbaum, Sharon Parrott, and Chad Stone, "How Low-Income Consumers Fare in the House Climate Bill," Center on Budget and Policy Priorities, July 8, 2009.

¹⁴ CBO estimates that the economy-wide costs of the legislation would average \$175 per household. Not all of the benefits and costs that go into that calculation were included in CBO's distributional analysis (because they could not readily be allocated among households), resulting in the lower figure of \$165 per household in the distributional analysis.

¹⁵ These figures represent CBO's analysis of the legislation as reported by the House Energy and Commerce Committee. Figures for the bill as passed on the House floor should be similar but not identical.

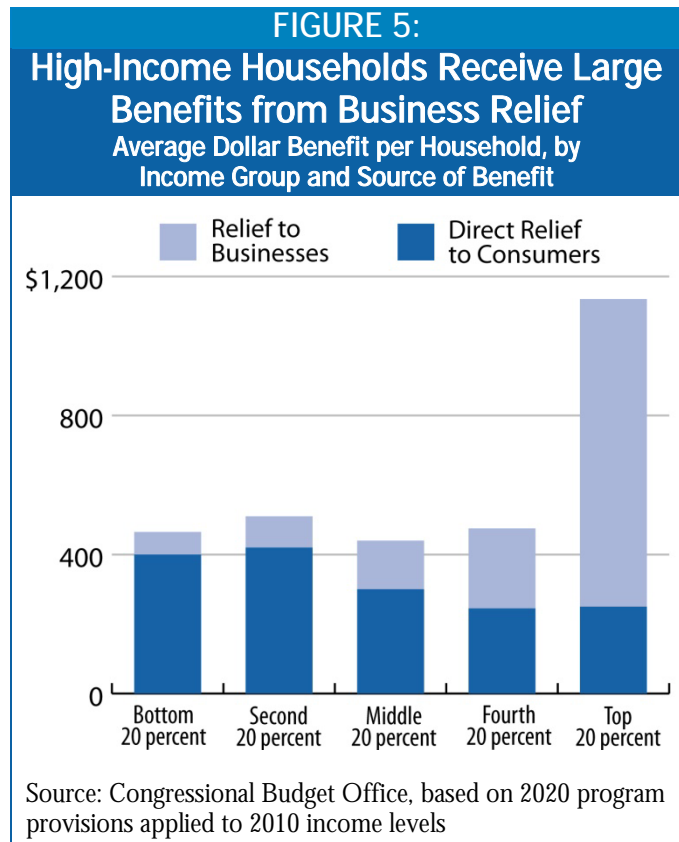
¹⁶ See Sharon Parrott, Dottie Rosenbaum, and Chad Stone, "How to Use Existing Tax and Benefit Systems to Offset Consumers' Higher Energy Costs Under an Emissions Cap," Center on Budget and Policy Priorities, April 20, 2009.

¹⁷ See Jennifer Kefer and Robert Greenstein, "Adding Funding to the House Climate Bill for Low-income House Energy Assistance Would Help Poor Families Facing Particularly Large Increases in Energy Costs," Center on Budget and Policy Priorities, July 8, 2009.

Finding the necessary funds to expand direct relief to consumers requires scaling back something else in the legislation. Based on the analysis in this paper, the obvious place to start is allocations that would function more like corporate welfare than well-targeted consumer relief. Free allocations to LDCs for their business customers, along with free allocations to electricity generators,¹⁸ are at the head of that list and account for a full 30 percent of the House bill's total allowance value.

With a substantial part or all of that 30 percent of the allowance value, it should be possible to provide a significant energy tax credit to millions of moderate- and middle-income households, as well as to fund a modest increase in LIHEAP. Moreover, since the residential LDC relief in the House bill would go to all residential consumers regardless of their income, scaling back that as well and using the savings to fund direct consumer relief would enable policymakers to offset more of the increase in energy costs that moderate-income households face, extend direct relief to households in the middle of the income scale, or some combination of the two. This would strengthen consumer protection where it is needed rather than channeling substantial dollar benefits to the top income quintile as the House bill does (see Figure 5).

The other major business provision in the House bill is relief for energy-intensive industries that face international trade competition, which might be scaled back some as well to free up allowances (see the box below).



¹⁸ These are the allocations to merchant coal generators and generators with long-term contracts discussed in footnote 4 above.

Free Allocations to “Trade-Exposed” Industries

In addition to its LDC provisions, the House bill provides free allowances to firms in “trade-exposed” industries, with a special allocation to domestic petroleum refiners. Proponents argue that unless Congress provides free allowances to companies that face competition from countries that lack comparable emissions-reduction requirements, any emissions reductions the U.S. emissions cap achieves would be partially offset by increased production by foreign competitors in countries without comparable emissions controls that increase their exports to the United States at the expense of U.S. producers or by a relocation of U.S. producers to unregulated countries.

Such emissions “leakages” are a legitimate environmental concern, and the effect of higher energy costs on U.S. producers is a legitimate competitiveness concern, but an ideal solution remains elusive. As Resources for the Future economist Richard Morgenstern testified before Congress, “Various policy options have been advanced to address these concerns, although none is without its own problems.”^a

Some form of policy toward trade-exposed industries is probably necessary, and the approach taken in the House bill is a viable option. However, targeting free allowances for this purpose has some of the same problems as free allowances to LDCs, such as distorting the pattern of emissions reductions and raising the overall cost of achieving those reductions. In addition, to the extent that firms are constrained by international competition from passing higher costs on to their customers, the benefits of these free allocations go to the shareholders (and workers) of firms receiving the free allowances and not to consumers generally. Morgenstern points to the additional risk that policies to help trade-exposed industries could provide “political cover for unwarranted and costly protectionism and may provoke trade disputes with other nations.”

For all these reasons, policymakers would be wise to look carefully at this policy. Such scrutiny might well show that it would be possible to lower somewhat the number of these allowances below what is provided in the House bill without compromising legitimate policy goals.

^a Richard D. Morgenstern, Senior Fellow, Resources for the Future, “Competitiveness and Climate Policy: Avoiding Leakage of Jobs and Emissions,” Testimony before the Committee on Energy and Commerce, U.S. House of Representatives, March 18, 2009, p. 3.

Conclusion

The House-approved American Clean Energy and Security Act marks an important step toward combating global warming while also protecting low-income consumers. For households that are not low-income, however, the bill’s principal mechanism to offset higher consumer costs is inefficient and much less effective than spending a comparable amount to provide direct consumer relief through the tax system and existing benefit delivery systems.

The politics of making substantial changes to the bill in the Senate may be difficult. Nevertheless, there are sound policy grounds for reducing the corporate welfare provisions of the House bill — especially the LDC provisions for commercial and industrial users — and boosting the resources for well-targeted direct consumer relief (as well as more adequately meeting other environmental needs). Such a reallocation could reduce the costs the legislation would impose on moderate- and middle-income households from their already modest levels to minimal ones.