Obama should seek alternative to cap-and-trade

President Obama's proposed budget promises to reverse "an era of profound irresponsibility." The budget identifies energy policy as one of the many areas in need of change. Our government should pursue important goals such as preserving the environment and reducing dependence on foreign oil to improve national security. Unfortunately, the president's proposal to enact a cap-and-trade system to limit carbon emissions takes the wrong approach.

In a cap-and-trade system, the government would first determine the maximum amount of carbon emissions permitted. This sets the "cap." The government would then auction off "allowances" to companies that emit carbon. An allowance authorizes its owner to release a certain amount of carbon into the atmosphere. Allowances would be tradable and their value would fluctuate based on changes in demand. This would allow market conditions to determine how much it costs to emit carbon.

The budget projects that money brought in from auctioning allowances will provide enough revenue to fund $15 billion in "clean energy technologies" and $60 billion in tax credits for working families annually through 2019. This would wean us from our current dependence on foreign oil and provide much-needed tax relief to middle- and lower-income families. Sounds good so far.

But there are major downsides to the proposal. First, cap-and-trade will cause a significant increase in energy costs. Carbon emitters will pay for allowances by passing the cost through to consumers. Who will be purchasing the allowances? Among others, utility providers. This means that we can expect to see significant increases in our electricity bills.

The Obama administration acknowledges this problem and responds by pointing to the annual $60 billion in tax credits that it intends to return to taxpayers as a way of mitigating the increased energy costs. This is called revenue recycling. The government institutes a policy that results in an increased cost to consumers, but then returns at least some of that increased cost in the form of a tax break. The question is whether the tax break will match the cost increase.

A second major problem is complexity. The cap-and-trade system requires that the government establish a totally new regulatory regime. This regime will have to combine technical monitoring (to make sure that emitters don't exceed their permitted allowances) with securities regulation (to oversee trading of the allowances). In effect, allowances are like tradable securities, only more complicated. Given the government's recent performance in regulating markets, can we have total faith that a new regulatory regime will succeed?

The government should dump the cap-and-trade proposal and simplify. Cap-and-trade is really just a tax wrapped up in the more politically palatable jargon of "market-driven" regulation. If the government needs to reduce carbon emissions, then it should be honest with taxpayers and simply enact a carbon tax. A tax could be structured to bring in the same revenues as cap-and-trade and would eliminate the unnecessary bureaucracy and uncertainty inherent in creating a trading system.

Unfortunately, taxes aren't politically feasible. That's why we're likely to be saddled with another bloated and ineffective regulatory agency to monitor a new cap-and-trade system. We can only hope that when it comes to regulating a complex trading system, the government's past performance is no indication of future results.

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