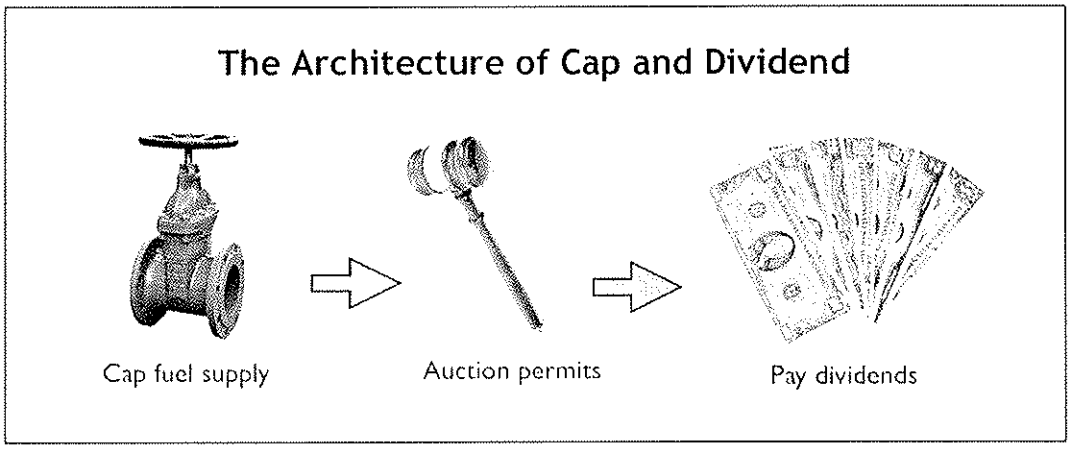
TESTIMONY OF PETER BARNES
TO THE HOUSE WAYS AND MEANS COMMITTEE
September 18, 2008

I come before this committee as an entrepreneur, author and father who cares deeply about this country and the future we are leaving to our children. Among other things, I ran a solar energy company in the 1970s when, briefly, tax credits made solar energy competitive with other forms of energy. I also co-founded a socially responsible investment company and a telephone company, and have written two books about climate change, *Who Owns The Sky?* (Island Press, 2001) and *Climate Solutions: A Citizen's Guide* (Chelsea Green, 2008).

I am here to discuss *cap and dividend*, a climate policy that is simple, fair, effective and market-based. Cap and dividend allows us to reduce carbon dioxide emissions to the levels scientists are calling for, while protecting the incomes and purchasing power of American families.[1]

Cap and dividend has three steps: (1) cap the carbon supply economy-wide; (2) auction 100% of the permits; and (3) return 100% of the proceeds to the American people in the form of equal monthly dividends.



This policy is based on two major premises. The first is that the root cause of climate change is a market failure – the fact that the costs of dumping carbon into the atmosphere are not paid by those who do the dumping, but are shifted to future generations. This market failure can be fixed by a carbon tax or a carbon cap. For political reasons I think a cap is more viable than a tax, but a cap is tricky because it can easily be done wrong.

The second major premise is that the air we share is a gift of creation to all. This means that the economic value that arises from fixing the market failure – what economists call the 'rent' we must charge for dumping greenhouse gases into the air – also belongs to everyone. That rent should not be given away to polluters or other special interests. Rather, it should be used for the benefit of everyone.

[1] More information about cap and dividend is available at www.capanddividend.org.

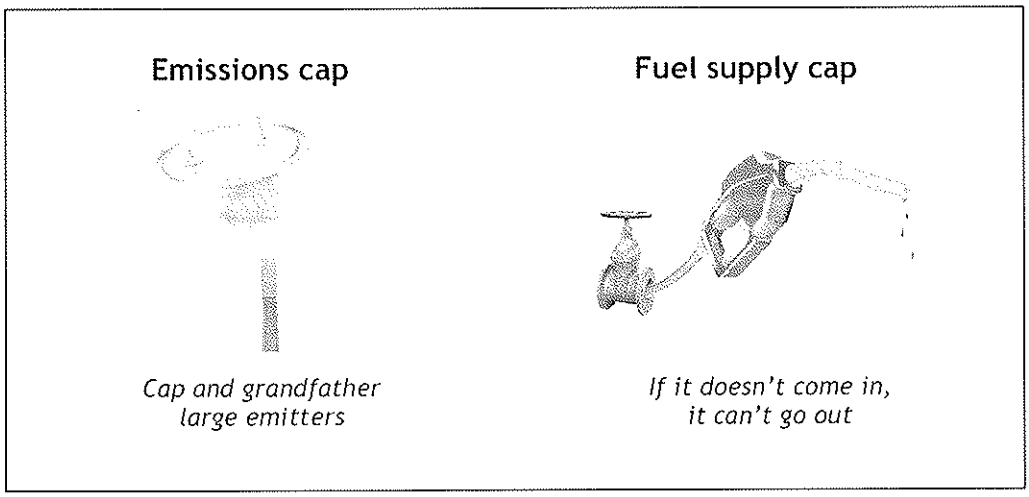
Let me explain the key features of cap and dividend in more detail.

(1) The cap

The cap is an 'upstream' cap – that is, a cap on carbon *suppliers* rather than carbon *emitters*. In this sense it is different from the cap on sulfur, and the reason is that carbon is a different pollutant from sulfur. It doesn't flow from a few large smokestacks; it flows from hundreds of millions of pipes large and small. Trying to cap carbon emitters is therefore extremely difficult. To the extent it can be done, it will be an administrative nightmare for businesses, consumers and government, and it will never catch all the carbon flowing into the air.

By contrast, capping carbon as it enters the economy is relatively simple. The cap can be administered by requiring the first sellers of oil, coal and natural gas to buy permits equal to the carbon content of their fuels. Once a year the companies would 'true up' and pay a stiff penalty if they don't own enough permits. No other businesses would need permits, no smokestacks would need to be monitored, and no large government bureaucracy would be required.

The cap would apply only to a few hundred large companies like Exxon-Mobil, Peabody Coal and El Paso Natural Gas. These are the same companies that would pay a carbon tax under legislation introduced by Representatives Pete Stark, John Larson and others. The difference is that, under a supply cap, these companies would purchase permits instead of paying a tax.



A cap works by issuing permits and then gradually reducing the quantity of permits. In other words, it's like a valve we crank down year after year until we reach a safe level of emissions. The key point of an upstream cap is, *if carbon doesn't come into the economy, it can't go out.*[2]

[2] A separate question is whether offsets and/or safety valves should be allowed to weaken a cap. I believe they should not.

(2) The auction

A crucial question with any cap is, should permits be issued for free or sold at auction? In the case of sulfur, permits were given to historic emitters for free, but we shouldn't do the same thing with carbon. The reason is that, while the economic value of sulfur permits was small, the economic value of carbon permits is immense. As the European experience has shown, issuing free carbon permits leads to higher prices for energy users and windfall profits for the companies that get free permits.

By auctioning permits, the economic value of the atmosphere can be captured by the public and used for the common good. This is what several northeastern states are now doing, and what Senator Barack Obama, the Democratic Presidential nominee, has called for doing at the national level.

In practice, the Treasury Department could conduct periodic competitive auctions of carbon permits, much as it does with Treasury bills.

(3) The dividends

When fuel companies buy permits, they'll pass that cost along to their customers. This is as it should be: the cost of emitting carbon *needs* to be paid by energy users. By adding this currently ignored cost, we'll shift private investment away from fossil fuels and toward efficiency and clean energy.

Higher fuel prices have a big downside, however: they take lots of money out of everyone's pockets. The trillion dollar question is, where does that money go?

If carbon permits are given free to emitters, the higher prices everyone pays will go to private companies. However, if carbon permits are auctioned, the auction revenue can either be spent by the government or returned to the people.

I believe that the best thing to do with the carbon auction revenue is to *give 100% of it back to the American people in equal monthly dividends*. This can be done efficiently through a system of monthly electronic transfers, similar to Social Security. Payments would be wired directly to people's bank or debit card accounts. These payments could be distributed by the Financial Management Service, a branch of the Treasury Department which manages disbursements for Social Security, veterans' and other benefit programs.

Like Social Security benefits, these dividends would be taxed as ordinary income. In this way, the federal government would recoup about 25 percent of the auction revenue, and could use this revenue as it sees fit. This revenue recovery would be done progressively through the income tax system, and the expenditures would be made through the normal appropriation process.

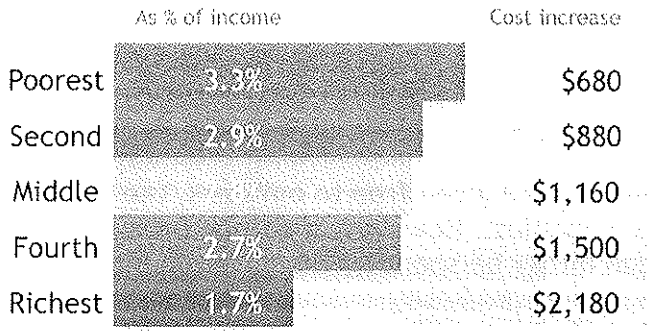
The rationale for cap and dividend

There are several reasons for returning auction revenue through per capita dividends. First, the money raised in permit auctions isn't manna from heaven. It quickly becomes a cost of goods sold and is passed on to the end users of fossil fuels. In other words, it has the same effect as a tax on fossil fuels. And as the cap declines, the effective tax rate goes up.

As the Congressional Budget Office has shown, this effective tax on fossil fuels will have a regressive impact on American households. Prices will rise not only for gas and electricity, but for all products that use fossil fuels in their production or distribution. This will place a disproportionate burden on low-income families, and the middle class will also be hard hit.

According to the CBO, the average U.S. household will pay $1,160 a year in higher prices when emissions are cut 15%, and that amount will rise as emission cuts go deeper.[3] So the number one reason for returning auction revenue to the people is to offset the impact of higher fuel prices.

What a 15% cut in emissions would cost different income groups



Source: Congressional Budget Office

Returning 100% of auction revenue in per capita dividends would cushion the impact of higher carbon prices on everyone. But for many families, it would do more — it would result in net income gains. The gainers would be those families that consume (directly or indirectly) less than the average amount of fossil fuels. For them, dividends would exceed what they pay in higher prices. Low-income families in particular would benefit from cap and dividend, as has been shown by the CBO[4] and other studies.[5]

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[3] Testimony of Peter Orszag to Senate Finance Committee, April 24, 2008. http://www.cbo.gov/ftpdocs/91xx/doc9134/04-24-Cap_Trade_Testimony.pdf

[4] Ibid.

Without going into details of these studies, the broad finding is that the bottom 40% of households would come out ahead, the middle 20% would roughly break even, while the top 40% — the households who burn the most carbon and can afford to pay for it — would show a loss.

These figures, of course, represent aggregates. The key point for individual families is: *any family that reduces its carbon burning can come out ahead.* This is what gives cap and dividend its political appeal. It creates a system in which fighting climate change isn't just about pain; it's also about potential gain. This builds a broad constituency for carbon capping that can sustain a decades-long transition. It makes every family a partner in a nationwide effort. And it does this without increasing the size of government.

Why not return auction revenue through tax cuts or tax credits?

In theory, revenue raised through carbon permit auctions could be returned to the people through a variety of tax reductions, rebates or credits. If this were done, the *amount* of money returned could be the same, but the delivery mechanisms would be different. So why are dividends preferable?

The first set of reasons is economic. Many families are struggling to pay mortgages, gas and utility bills. These families pay their bills every month, and can't wait until April 15 to receive a tax credit. They need real money every month.

Further, it's widely recognized that our economy is in recession; the last thing our economy needs is a decline in consumer purchasing power. In fact, many experts say the opposite: we need to boost consumer purchasing power with a stimulus. A system of monthly cash dividends, paid from carbon auction revenue, would sustain consumer purchasing power not only in the short term, but for the duration of the transition to clean energy.

The second set of reasons is political. Rising energy prices are an explosive issue. A carbon cap will raise fuel prices further, not just once, but for decades — indeed, that is its purpose. The potential for backlash and backsliding is enormous. If the cap is to succeed in reducing emissions to a safe level, it's crucial that the American people understand that the money they pay in higher prices comes back to them reliably and automatically.

There's no better way to remind people that they're getting money back than to send it to them monthly in cash. The trouble with tax credits — besides the fact that they only arrive annually — is that they're far less noticeable than cash.

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[5] James K. Boyce and Matthew Riddle, *Cap and Dividend: How to Curb Global Warming While Protecting the Incomes of American Families*, University of Massachusetts/Amherst, Nov. 2007, http://www.peri.umass.edu/fileadmin/pdf/working_papers/working_papers_101-150/WP150.pdf; J. Andrew Hoerner and Nia Robinson, *A Climate of Change: African-Americans, Global Warming and a Just Climate Policy for the U.S.*, Environmental Justice and Climate Change Initiative, July 2008, http://www.ejcc.org/climateofchange.pdf.

The bottom line on Form 1040 may be lower than it might otherwise have been, but the *reason* it is lower can easily get lost. And paying less on April 15, but still paying, doesn't produce the same positive effect as receiving a monthly payment.

Moreover, the tax code is uneven in its impacts and often opaque in its workings. By contrast, equal monthly dividends define a system that is self-evidently fair and easily understood.

As to why dividends should be universal, rather than limited to people earning below a certain level, the political logic is the same as for Social Security, Medicare and public education. The dividend isn't a welfare check paid by winners to losers. It's a birthright of all Americans, based (in this case) on the fact that we are all owners of the air. A useful precedent is the Alaska Permanent Fund, which for 25 years has paid equal dividends from state oil leases to every Alaska resident. History has shown that universal programs such as these are more popular and durable than programs that target the poor. They unite Americans rather than divide us by economic class.[6]

Why shouldn't the government spend some or all of the auction revenue?

In theory, the common good could be advanced by having the government spend some or all of the auction revenue. There is, arguably, no lack of good uses to which this revenue stream — hundreds of billions of dollars annually — could be put. The difficulties lie in actually deciding what to do with it, and in assuring that everyone (not just powerful interests) shares the benefits.

One possibility is to flow the money into the general treasury and let it be allocated through the normal appropriations process. But the temptation seems to be to pre-allocate the auction revenue by assigning it to a number of trust funds that stretch out for as long as 40 years.

Consider, for example, this year's Lieberman-Warner bill, which one Senator described as "the mother and father of all earmarks." For each year between 2012 and 2050, the Lieberman-Warner bill specified the number of permits that would be given free to various entities, and the percentages of auction revenue that would be similarly allotted. (See chart on following page.)

The trouble is not that the specified uses of this money were bad; some were indeed quite worthy. Rather, the trouble is that pre-allocating so much money for so many years isn't the normal way Congress manages the public purse. It ties the hands of future Congresses and Presidents for decades to come. And in the end, the tab for all this pre-allocated spending is paid by households in higher energy prices.

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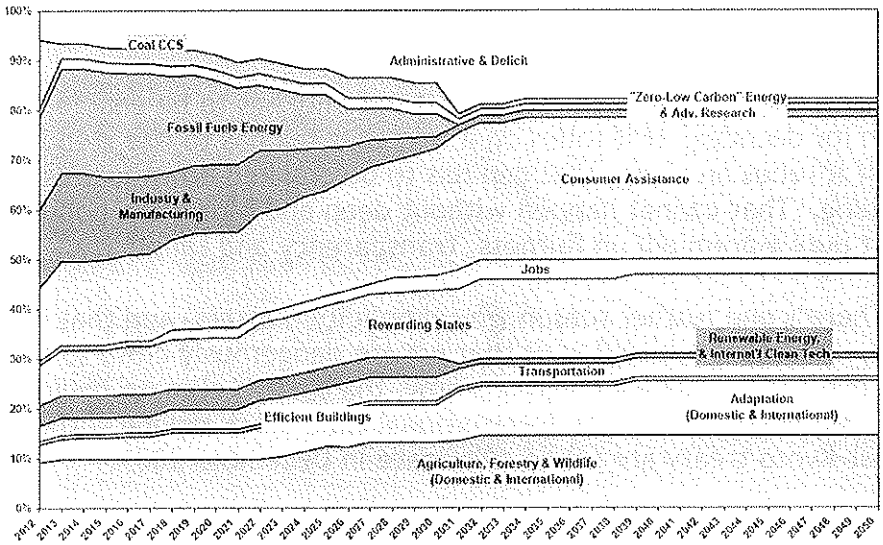
[6] It should also be remembered that, if dividends are taxed, upper-income Americans will pay 35% of them back to the government, while the lowest-income households will keep 100%.

Allocation of Permits and Auction Revenue in Lieberman-Warner[7]



The virtue of simplicity

The ultimate reason for giving all the auction revenue back to the people equally may be this: it has the virtue of simplicity.

The climate crisis itself is incredibly complex, and there is no single, simple fix for it. Many things need to be done by many people and institutions at many levels. But not all the things we need to do are of equal importance, and not all of them need to be done at once. It may make sense to prioritize — to do first things first, and secondary things later.

I would argue that the single most important thing we need to do — and the thing we need to do first — is install a descending economy-wide carbon cap. Once that is done, much else will follow. Markets will respond almost instantly. Billions of dollars of private capital will flow into clean technologies, creating millions of jobs. And public entities (including state and local governments) will also respond. They'll adopt green policies for transportation, scientific research, agriculture, job training, foreign aid and more — not all at once, but in the course of updating existing programs. These new policies will be funded from general revenue, from subsidies that now go to fossil fuels, and potentially from higher levies on oil companies.

Many members of this committee have supported a carbon tax in part because of its simplicity. Cap and dividend is not quite as simple as a carbon tax, but it is close. It is simple to administer — which is important for any program's

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[7] Friends of the Earth, www.foe.org/pdf/LW%20Allocation%20and%20Auction%20Distribution%20Charts.pdf

effectiveness — and it is simple to understand — which is important for any program's popular support. And let us be clear that popular support is *essential* for any climate policy to succeed.

For a climate policy to succeed, it not only has to be *enacted*, it also has to *function* for decades. If it relies on a tax, that tax has to rise steadily for 30 to 40 years. If it relies on a cap, that cap has to be cranked down just as steadily for just as long. That cannot happen without deep and bipartisan popular support. And that puts a premium on fairness, transparency and simplicity.

There's one further reason why simplicity matters, and that has to do with urgency. Scientists are telling us that we are dangerously close to a tipping point — if we don't start curbing emissions now, the earth's climate could spiral out of control. Moreover, there's an international time clock ticking — the negotiations for a post-Kyoto treaty are set to culminate in December 2009.

For both geophysical and geopolitical reasons, I believe the U.S. needs to pass an economy-wide carbon cap in 2009. And the more complicated such a cap is, the harder it will be to do that.

I may be naïve, but I think it's possible that a revenue-neutral (and technology-neutral) carbon cap — i.e., cap and dividend — could pass in the first 100 days of an Obama or McCain administration if it is sought by the new President. If this happens, it would send a much-needed signal to markets, and show the rest of the world that the U.S. is serious about tackling climate change. The new President could then credibly engage in the international negotiations that hopefully will produce a global framework later in 2009.

Such a revenue-neutral carbon cap would not preclude additional climate and energy policies. Indeed, it would pave the way for them by putting a durable cap in place.

So let me optimistically conclude by citing three common-sense precepts:

- Put first things first;
- Keep it simple;
- Don't take money from people unless we absolutely have to.

If we keep these notions in mind, 2009 could be a good year for our climate.

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