Rhode Island Policy Reporter

Issue 36 **20 April 2009**

Cap and Trade: Warming to the debate

Remember acid rain? The coming environmental apocalypse that was going to devastate wooded areas and agriculture all over America, but especially in the northeast. Do you ever wonder why we don't hear so much about it any more? Outrage-weary activists may be pleased to realize that the reason we don't hear so much about it is we actually addressed it, with an unsung public policy triumph called "cap and trade."

We're hearing a bit about this kind of regulatory scheme now, since it's one of the leading proposals for controlling global warming pollution. The EPA has declared greenhouse gases to be pollution we need to deal with. The next few months are going to decide how—or if—our country addresses global warming, as President Obama tries to get a workable program through Congress. But there is an obstacle: many people don't even know what cap and trade is, let alone realize that we have 15 years of experience with it, and have learned lessons worth knowing.

Here's how it has worked for acid rain. In 1995, the EPA established a fixed limit to the amount of acid rain pollutants that could be emitted by electric generating plants (sulfur dioxide, but nitrogen oxides followed the next year). They then created a system of permits to pollute, also called "allowances." Each allowance is like a coupon allowing your company to emit a ton of some pollutant. If your company emits 200 tons of sulfur each year, you need to come up with 200 allowances each year, or risk a fine for going over the number of allowances you have. Or you can cut your emissions.

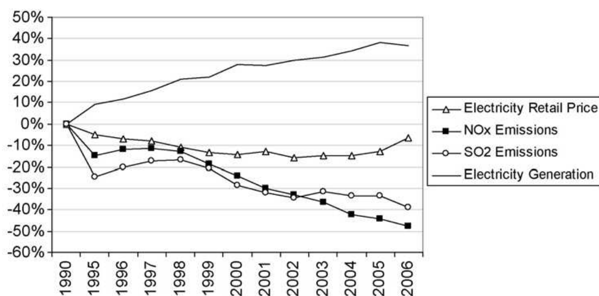

Figure 1: Change since 1990. Sulfur and nitrogen emissions—the prime culprits of acid rain—have gone down, as has the price of generation, while electricity usage is way up. The EPA uses a cap and trade regime to control these emissions. Source: EPA, via Napolitano, et al. The Electricity Journal, 20(7), August-September 2007, pp47–58.

How do you get allowances? Most of the allowances are distributed free according to a set formula, but a small number of them (2.6% of the total) are sold at auction. Companies are free to use the allowances themselves, to offset their emissions, or to sell them to other companies.[1]

At the time, critics said the scheme guaranteed emissions would only go down as fast as the EPA caps, and that something more dramatic was required. Plus it simply felt wrong to many to be selling permission to pollute. Instead it was argued that pollution should just be forbidden. As is often the case, sometimes it's good to step back and remember the overall goal.

It's easy to criticize or call for government regulation of this or that, but regulation isn't free or even particularly easy. Rules have to be set and enforced, which costs time and money, and awkward decisions made, which often costs credibility. Say you have two similar factories to regulate who are both polluting some stream. To stop the pollution, one scenario is that you demand they stop and they do so by closing down and moving to Mexico or China. If you want to avoid that outcome, you can demand they phase in new technology to reduce the problem. But suppose there is some kind of barrier to using the new pollution-reduction technology in one of the factories. Maybe it doesn't have the room or the capital, or maybe it hasn't been invented yet for the brand of machine in use there. Do you shut the factory down or let it continue polluting? The question isn't just what's fair to that factory, it's also what's fair to the other factory, the one that *can* afford to use the new technology.

We've addressed acid rain with "cap and trade" and the record is encouraging—and instructive.

In any kind of regulatory regime, a thousand little questions like this one lurk around the big decisions about how to get the overall level of pollution lower. Regulators frequently find themselves unable to avoid favoring one company over another (or unable to avoid accu-

[1] Until 2006, they were sold at the Chicago Board of Trade, along with wheat and pork belly futures.

sations of bias, just as bad). This is a recipe not just for complaint and friction, but also for ineffective regulation.

Enter cap and trade. The idea here is that regulators get to concentrate on the big picture, while a market mechanism is used to work out the details. A company that finds it easy to install more efficient equipment and reduce its pollution can find a windfall profit selling its allowances to other firms. This is precisely what has happened. The EPA concentrated on creating a network of sensors that allow it to monitor precisely how much sulfur dioxide is being emitted by whom, while allowing companies to buy, sell, and trade allowances among themselves. Currently, the fine for emitting sulfur dioxide beyond your allowances is over $3,000 per ton, and the price of allowances wanders between $500 and $600 per ton.

There are important components to success with cap and trade.

The results are promising. Acid rain pollution has plummeted, at low cost (see figure on page 1). President Obama has made it clear that he favors some kind of cap and trade proposal to reduce carbon dioxide pollution and thereby reduce global warming. We've run the acid rain program since 1995 and European agencies have run a not-quite-as-successful cap and trade program to reduce global warming pollution since 2006. From our own experience and theirs, we've learned some lessons about what makes these programs successful.

1. Make the cap low enough.

   In order for the market to work, the pollution cap must be set low enough for pollution allowances to have any value. If the cap is too high, no one needs to buy any allowances, and the market pump won't be primed.

2. Careful monitoring is essential.

   The whole cap and trade edifice rests on a foundation of thorough pollution monitoring. Companies buy allowances because they know that emitting pollution without allowances will lead to large fines. Combined with a low cap, that's what makes the allowances valuable.

3. Capture some of the money in the market by auctioning allowances.

   There's a lot of money in the acid rain allowance market, and the whole scheme isn't free. A carbon scheme will have a lot more money in the market, and be much more expensive. Adequate monitoring, for example, can be very costly, and the effects on the economy—especially the impact on poor people—will be large. Auctioning permits in order to recoup some of the costs of the program is essential to offset these problems. (See box.)

Critics point to the volatility of allowance prices in the sulfur market as a sign that prices do not reflect compliance costs. In a way, they are right. For example, the price jumped from around $200 at the beginning of 2004 to almost $1,600 at the end of 2005 before subsiding to the $500 neighborhood a few months later.

But this isn't surprising. The neo-classical economic theory that the price of a commodity at any time reflects all the information known about that commodity is largely a crock, true only in a superficial way, if that. The allowance market is like many others, overreacting to some stimuli and underreacting to others. The 2005 spike turned out to be largely because companies had not been investing in new technology, but simply switching to low-sulfur coal. In other words, they had found a way to avoid cleaning anything. But reality hit in 2004, when the EPA announced they'd be tightening the cap in 2010 and again in 2015. That, combined with sudden price hikes in the fuel markets, caused the companies to overreact, but the spike only lasted a few months before the panic subsided, and buyers realized there were plenty of realistic ways to meet the new caps.[2] Despite the fuzziness of the "'signal" sent by allowance prices, the program is still useful because of the regulatory burden lifted from the government.

Pricing externalities In the coming months, you'll hear people complain about the cost of a carbon cap, and how it's a hidden tax of ruinous cost, and much more.[3] These critics present the debate as a choice between paying higher energy prices and paying nothing, imagining somehow that the cost of doing nothing is zero. This is plainly false. No one is blind to the impact of higher energy prices, but there are very good reasons for making the price of using energy reflect its true cost. Just to take one example, quite a lot of Rhode Island is low swampy

Rhode Island Policy Reporter
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subscriptions: $35/11 issues, $20/6 issues
editor & author of unsigned articles: Tom Sgouros
Issue 36 ☮ 20 April 2009 (1.3)
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[2]What's more, the price rises experienced in the allowance market was dwarfed by the price jumps of other energy commodities, such as oil and natural gas.

[3]See for example, "Who Pays For Climate Policy" from the Tax Foundation, *www.taxfoundation.org/files/wp6.pdf* or "The True Costs of EPA Global Warming Regulation" from the Heritage Foundation, *www.heritage.org/research/energyandenvironment/bg2213.cfm*.

ground. Minor rises in sea level will be phenomenally expensive to towns like North Kingstown, Charlestown, Warren and Barrington.

Economists talk about "externalities" to markets, and what they mean by that is factors that aren't incorporated into the price of those goods. For example, I'm typing this essay on a computer whose price did not incorporate the substantial cost of throwing it away when it finally dies. It contains several dangerous elements, like lead, copper, mercury and cadmium. The cost of taking the thing apart safely is not part of its purchase price, even though its demise is just as inevitable as turning it on for the first time. Accumulated consumer electronic trash is one of the big toxic waste problems facing our world. An EPA estimate from 2005 was that over 130 million cell phones (65,000 tons) were thrown away that year in the US alone.

We must make the price of energy equal to the cost, which it isn't now.

At its root, cap and trade is an attempt to create a price for the cost of pollution. For exactly that reason, it's important that some of the higher price be recovered in order to use it in a socially useful way. The real question at hand isn't whether there will be increased costs to energy use, but whether we use the increased cost to slow the warming, or simply suffer the increased cost as a consequence of global catastrophe.

Alternatives One of the alternatives to cap and trade is a simple carbon tax. This would be a tax on gas, coal, oil intended to do the same as the cap and trade but more directly, by raising its price. Proponents of a simple carbon tax say that simply increasing the cost of carbon fuels will provide the same environmental benefit as a cap and trade scheme. But on what evidence?

Market-based solutions are one thing, but boundless faith in "the market" is something else. The energy market is a tremendously complex thing, and reducing carbon dioxide emissions a difficult objective.

Cap and trade uses a fairly simple auction market to accomplish a known public policy objective: reducing greenhouse gases. We focus on the trading because it's a novel and interesting solution to allocating the costs of compliance with these laws, but there is a cap, too. The cap does the environmental work, and the market mechanism only determines who reduces how much. The carbon tax, on the other hand, relies on our understanding of the mechanics of a fantastically complex energy market to predict how much reduction of carbon dioxide pollution will be accomplished by what level of tax. Which is more likely to achieve its goals?

The carbon tax will raise the price of fuel, certainly, but despite what market fundamentalists say, just because the price of a commodity is raised doesn't mean less of it will be used. A higher cost of fuel might increase the sales of high-efficiency cars, lowering their price dramatically, and consumers would see the savings in the overall cost while spending more for gas. Sure you could always impose a carbon tax high enough to make this an improbable outcome, but how likely is that?

Economists have known for years about something called the "Jevons paradox." Named for William Stanley Jevons, a 19th-century English economist, he noticed that, though the steam engine became tremendously more efficient in the early parts of the 19th century, the overall use of coal *increased*. Another way to say it: Efficency gains do not have to go to reducing fuel use. A Lincoln Navigator has a far more efficient engine than a Model T, but the efficiency has been used to pull more weight, run air conditioners and power windows and so on, so the gas mileage is about the same.

This is what's so very wrong about imagining that mar-

*How **not** to lessen the impact*

What about the impact on consumers? Like it or not, a realistic program to combat warming pollution will mean a substantial price increases in basic energy needs for everyone. As detailed in a Congressional Budget Office report,[a] this is likely to have a significant regressive impact, hitting poor people much harder than the well off. The best idea would be to use some of the proceeds of auctioning permits to offset some of these impacts (the best argument for auctions) but there are right ways to do this and wrong ways. In other words, you *want* the cost of energy to be high, or else the behavior doesn't change, sea levels rise, and the cost on everyone becomes far far higher than any measly fuel tax could ever be. Of course, you also want poor people to have extra money to spend on fuel so they don't become poorer. The proceeds of the auction are a likely source of funds, and the best reason for hoping that we don't give away allowances for free.

This money should be used for public transit and for other ways to decrease energy use (home insulation and efficiency improvements or renewable energy subsidies). Much government spending is progressive in nature, helping more the lower on the income spectrum you are, and these kinds of investment would be no different. It would also be effective to use some of the funds for lowering other taxes on the bottom end of the income spectrum, as the CBO report suggests.

What it should not be used for is to offset or discount energy dollars specifically, since that would undercut the effect of higher prices on people's behavior. We need a world where you can save real money by taking the bus, insulating your house, or simply choosing to live where you don't have to drive as much. What we also need is a world where those choices exist.

[a] *http://www.cbo.gov/ftpdocs/100xx/doc10018/03-12-ClimateChange_Testimony.1.1.shtml*

ket forces and "peak oil" are going to solve this problem for us. It's often stated that scarcity leads to higher prices and higher prices lead to decreasing use, but this is simply false. Neither the housing nor the employment markets work this simply. Why should energy?

Of course housing and employment are not commodity markets, but there are commodities with counter-intuitive markets, too. According to USGS statistics, there is about six times as much mined gold in the world today as there was in 1900. With only about four times as many people, gold is less scarce today. And yet the price of gold in real terms is much higher today than it was in 1900.

The simple economist's tale is only mostly true, and only in the average. Scarcity often, but not always, leads to higher prices and higher prices often, but not always, lead to decreased usage. But increased carbon dioxide in the atmosphere *is* leading us toward rising sea levels, increased storms, bizarre weather, drowned polar bears and all the rest, and I want some certainty in my solutions. Relying on some economists' superficial understanding of a market we can't control provides far less certainty than a global cap, and certainty is what we need.

In the coming months, there will be debates about what kind of energy policy the US should pursue. There are serious challenges ahead whatever the choice. Even after facing the nicks and cuts of a fight in Congress, there will be international coordination to invent, with their complicated conflicts between rich and poor countries. These are not going to be easy fights. But the research shows us that prompt and vigorous action will have an effect. We have experience enough to know what works. The question now is whether we have the will to use it. ■

The secret behind the debate over secret ballot union elections

PETER ASEN

The debate over the Employee Free Choice Act (EFCA) goes back and forth about whether card checks or secret ballots are fairer or more effective ways to establish a union. But it turns out that there is a far more important issue hiding behind it, that rarely gets any attention at all. These are measures to force an employer to negotiate with a union at all.

On March 10, EFCA, a bill to make it easier for workers to form a union, was introduced by Senator Ted Kennedy (D-Mass.) and Representative George Miller (D-Calif.) The bill had been introduced in previous years, and even passed the House of Representatives in 2007, but the current introduction is the first time that EFCA has seemed like it could pass, given that there is no longer a president ready to veto any pro-union legislation.

At a time when just 12 percent of American workers belong to a union, down from a peak of 35 percent four decades ago, EFCA is intended make forming a union easier for American workers. The best-known portion of the bill is that it would allow workers a process outside of the current National Labor Relations Board election process. NLRB elections take at least six weeks to conduct and give management plenty of time to intimidate, cajole, and bribe their employees away from voting for the union.

It's not the card check, but whether employers must negotiate at all.

Under EFCA, management would be required to recognize a union once a majority of the workers sign cards saying that they want the union. Today, if that majority signs such cards, even if it is, say, an 80 percent majority, management can still refuse to recognize the union and force the holding of an election. In 2002, I worked as an intern on a union organizing campaign at a Providence nursing home where the union filed for election with more than two-thirds of the workers having signed cards. A few months later, the support had been decimated by a ferocious anti-union campaign.

One of the favored tactics of employers in these sorts of campaigns is to illegally fire, demote, or suspend one or more employees who are playing a lead role in the effort—which serves both to take away some of the organization and scare the hell out of all the other employees. Management fires workers in some 25 percent of organizing drives, and 23,000 workers per year receive back pay for having successfully proven that their employer illegally fired, demoted or suspended them, according to a study by American Rights at Work. But the expense of back pay[4] and an extended legal battle is more than worth it for many employers if it breaks the union organizing effort. EFCA would stiffen the very weak penalties for employers who break the law, making this a less appealing alternative for employers.

The Bosses Fight Back Faced with the first serious effort at pro-union labor law reform since the 1970s[5] business leaders have been gearing up to defeat the bill, with one anti-union group having spent $20 million in television ads last year against Democratic US Senate candi-

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[4]Usually reduced by other pay the worker has earned elsewhere.

[5]That one failed, by the way. It was a comprehensive reform intended to speed up procedures for union recognition and overcome common obstacles to organizing new unions. It passed the House by a comfortable margin, but failed in the Senate only because it couldn't overcome a Republican-led filibuster, despite the support of 14 Republicans and 44 Democrats. Seventeen Democratic Senators voted against cloture, and the measure had only the tepid support of President Carter.

dates who supported EFCA, and the CEO of Home Depot having called the bill "the demise of a civilization."

The anti-EFCA campaign has largely centered on the notion that the bill will "take away" the right of workers to have a "secret ballot election"—and foes have conjured up visions of union thugs forcing workers to sign cards or punishing those who refuse. This management strategy is shrewd, in that it is based on the piece of the bill that polls show has the least support. The support is particularly weak if it is presented as an infringement on workers' rights to a secret ballot. The corporate types have even created front groups with names like Coalition for a Democratic Workplace and the Alliance for Worker Freedom. Ironically, workers do not currently benefit from a true secret ballot election in the sense that we experience elsewhere in our democracy. For example, one side (management) can force employees to go to anti-union meetings and even one-on-one grill sessions with supervisors and the other (the union) cannot even go onto the property.

In fact, EFCA would not prevent workers from petitioning for a union election—but the truth is that the "secret ballot" issue is not even what has the panties of management in a bunch. There is another piece of EFCA, which management opponents never talk about in public but which keeps them up at night—the requirement for first-contract arbitration.

No contract, no biggie? Under current law, management is required to sit down and bargain in good faith with a new union when the union organizes—but again, what that means in practice is a far cry from what you might expect. Some companies simply refuse to come to the bargaining table and force the union to issue a complaint, dragging out a long legal process. Others come to the table but really do not bargain in good faith, offering little better than the wages and working conditions that made workers want to form a union in the first place—or they bargain with the hope of getting to an "impasse," where the two sides are fully at odds and no further progress can be made, at which point management is no longer has a legal "duty to bargain," according to current labor law.

In all these cases, the goal is to drag out the process for so long that enough workers decide to give up fighting, thereby eroding union support and making successful negotiation of that first contact impossible. Indeed, 44 percent of newly certified unions never get a first contract. In Atlantic City, the roughly 500 dealers at Trump Plaza Casino and Hotel voted by a more than 2 to 1 margin for a union two years ago, and though they don't yet have a first contract, they are still fighting—though by two years on, many others have given up.

Today, 44% of newly certified unions never get a first contract.

EFCA would prevent these delay tactics by allowing unions (or management) to request mediation and then binding arbitration. The bill says that if an employer and a union are unable to reach agreement within 90 days, either party may request mediation. If the mediator is unable to bring the parties to agreement after 30 days of mediation the dispute will be referred to an arbitrator, whose decision will be binding for two years.

This provision is not just a threat to the most rabidly anti-union employers. Even those employers who agree to a first contract but are tough negotiators may fear first contract arbitration, if they fear that the process could deliver a contract more beneficial to workers than collective bargaining. Of course, first-contract arbitration could also result in a contract more beneficial to management too, but most in the labor movement seem to believe that the benefits of ensuring a first contract will be signed outweigh the risks that those contracts will be weaker than what they might negotiate.

So if employers are so concerned about the possibility of first contract arbitration, why haven't we heard anything about it? Well, it gets back to that polling. Employer groups realize that they will get little public traction by arguing, "if a majority of our employees choose to join a union, we want to maintain the right not to bargain with them, or to delay them to death." Somehow, it's hard to see a group like the Coalition for a Democratic Workplace getting behind that kind of message, no matter how misleading its name.

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Or, as J.P. Fielder from the US Chamber of Commerce put it recently to a reporter from the National Law Journal, "I think the secret-ballot provision is a part of EFCA that builds public awareness of the issues. . . but there is broad understanding in the business community that the binding arbitration provision is something we will absolutely go to the mat to fight."

What happens on that mat, likely over the next six months, will determine whether organized labor will have the legal reform many unionists believe they need to stage a real comeback. Will unions continue to be an increasingly marginal force in American society, complete with the stagnant wages and growing inequality that have accompanied the union decline of the past 35 years? Or will some version of EFCA pass and usher in a new labor upsurge, changing the face of 21st Century American capitalism as we know it? It is a battle worth watching. ■

Book Review

Report of the Governor's Tax Policy Strategy Workgroup, Dept. of Tax Policy, 2009, 222 pages

A few weeks ago, the Governor's blue-ribbon commission on tax reform came out with its final report. To no one's surprise, it endorsed pretty much everything the Governor wants: lower taxes on everyone, especially rich people and businesses, while ignoring the problem of municipal finance altogether. And now these proposals—including the complete elimination of the corporate income tax—are part of the proposed FY10 budget.

Let's review the actual evidence, much of which is reiterated in this very report: our income tax puts us in the latter part of the pack among states, our sales tax is among the highest *state* sales taxes, but we have no county sales taxes, which puts us in the minority. We have high property taxes, but the commission only came up with a way to "call" for lower property taxes, something a little different than a proposal to deliver those lower taxes.

The commission acknowledges that its proposals may need to be phased in over a long time. This is fine with me so long as we announce what expense it is we're also phasing out. People who advocate tax cuts should have their arms twisted around until they confess what they'll cut to pay for their tax cuts. If they can't say, they should be laughed out of town. Of course, the budget simply phases out the corporate tax in 2011, without word about what pays for that.

The report isn't a bad read. It has lots of references to useful research, and even acknowledges that land-use planning is relevant to fiscal policy, even if both were ignored in the end. The report acknowledges there is no evidence that lower capital gains tax rates do much of anything, and proposes restoring them to be taxed at normal rates, a small bright spot.

Of course, no good piece of literature is without its conflict. In this case, the conflict is provided by dissents from the only two out-of-state members of the workgroup: Michael Mazerov of the Center for Budget and Policy Priorities and Bob Tannenwald, of the Boston Federal Reserve. Tannenwald complained that the proposal to eliminate the corporate income tax was sprung on the commission at the last minute, and Mazerov made a detailed condemnation of the panel's reading of the business location literature.[6] Read together, they are a scorching indictment of how policy is made in Rhode Island today—read them and weep. ■

[6] See "Cut it and will they come?", **RIPR** issue 10, April 2005.

Have a group that would like to hear *"Ten Things You Don't Know About Rhode Island?"* Contact RIPR HQ today!

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