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Climate Change Legislation – Tax Considerations

Statement of

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Mr. Chairman and members of the Finance Committee, thank you for inviting me to testify on this important subject. My name is Gary Hufbauer and I am a Senior Fellow at the Peterson Institute for International Economics and co-author of *Global Warming and the World Trading System.*

Climate change is a serious problem that must be addressed by the United States and other countries. To reduce greenhouse gas (GHG) emissions, a carbon tax system would be vastly superior to a cap-and-trade permit system. Carbon taxes would be more transparent, more uniform across all GHG sources, raise more revenue, easier to administer, and more readily adjusted at the border. The Waxman-Markey draft legislation illustrates the enormous complexity, opacity, and rent-seeking inherent in a permit system.

That said, political forces strongly favor a cap-and-trade permit system. My purpose today is to comment on the tax and trading aspects that arise from system of issuing carbon permits. I use the term "carbon permits" as shorthand for permits covering any GHG source, equated on a carbon dioxide equivalent basis (CO2e).

Are free allowances of carbon permits income? This is the threshold question, and my answer is a decisive "yes". When the US government issues free permits, it is already conferring a big favor on recipient firms. It would be a travesty to double up the favor by exempting these permits from the definition of income for the purposes of the Internal Revenue Code. An analogy to other valuable but untaxed permits, such as zoning decisions or immigration visas, is misplaced. Those permits are inherently non-tradable. A central argument for a cap-and-trade system is to encourage efficient reduction of CO2e through the purchase and sale of permits. Freely allocated carbon permits excuse the recipient firm from purchasing the same; they have an ascertainable value; and if the system is properly designed they may be sold. Accordingly they should be taxed as income at their value on the date of issue. If the permits are sold at a later date and at different values those transactions would give rise to trading income, discussed later. The Committee should reject proposals that would have the effect of making freely allocated carbon permits non-tradable and therefore difficult to value.

Is the purchase of carbon permits a business deduction? When the purchaser uses the permit to satisfy its own GHG obligations, again my answer is a decisive

"yes". This is an "ordinary and necessary" business expense. Two refinements should be noted. If the permit is purchased in year one, but not used until year two, the deduction should be claimed in year two. If the permit is purchased and later resold (not used by the purchasing firm), that transaction would give rise to trading gains or losses, discussed next.

Trading in carbon permits: type of holder. The rules for taxing gains or losses realized on trades in carbon permits should not distinguish between types of holders – industrial firms, banks, hedge funds, etc. Making such distinctions will invite creative arbitrage. If the holder is a tax-exempt entity, such as a pension fund like Calpers or a foreign sovereign wealth fund, it will of course escape any taxation of gains or recognition of losses.

Trading in carbon permits: type of income. My recommendation is to treat all trading income as ordinary income, not capital gains. This means higher tax rates would normally apply to trading gains, but it also means trading losses would be recognized as a deduction against ordinary income. This recommendation reflects my general distaste for extending capital gains treatment to income earned by business firms. I recognize that many capital gains provisions are already embedded in the corporate tax code, but I see no reason to extend a bad practice to new forms of trading income.

LIFO or FIFO? My recommendation is FIFO, on the expectation that the value of carbon permits will rise over time. I see no merit in allowing firms to choose between LIFO and FIFO for fungible permits, or even worse to designate which permits are sold out of a large portfolio of holdings. Of course permits may be issued with different characteristics (expiration date, industry of final use, etc.), and those will be distinct securities.

Oversight and regulation of trading in carbon permits. I am a believer in financial markets. I am not a believer in unregulated, over-the-counter markets. If the United States creates a system of tradable carbon permits, it should simultaneously authorize one or more exchanges to handle trades in these permits. Trading outside the exchanges should be prohibited. The beneficial buyers, sellers, and holders should be regularly disclosed (no street names), and prices and volumes should be posted on a real-time basis. The extinction of permits through

GHG emissions should also be disclosed. In other words, the CFTC should do its job. The same goes for derivatives (futures, options, etc.) which have carbon permits as their foundation. Margin requirements must be set and enforced.

Permits purchased by foreign firms. To the extent permits are required of foreign firms exporting goods into the US market, the permits should be purchased on the authorized exchange. There is no reason to create a wedge between the value of a permit to emit a metric ton of CO2e when acquired for use in the United States and its value when acquired by foreign firms to meet US GHG requirements on production abroad. In this statement, I will not comment further on appropriate approaches for determining the GHG requirements that can be properly applied to US imports of goods produced abroad. That subject is discussed in detail in our book *Global Warming and the World Trading System.*

Offsets purchased by US firms. Offsets purchased from foreign entities that claim to reduce their CO2e emissions must be closely regulated. Offsets should be authorized by the EPA, following a close examination of the foreign program. They should be purchased and sold only on the authorized and regulated US exchange – not on shadowy over-the-counter markets. They should be fungible with US-issued carbon permits. This will foster a single world price per metric ton of CO2e emissions – a goal that the United States should champion.

Collars – floors and ceilings on permit prices. European experience proves that the price of carbon permits can be extremely volatile. Volatility undermines the basic purpose permits are meant to serve – to encourage long-term planning and investment to curb GHG emissions per unit of output, but not to put firms out of business because the price of permits suddenly spikes. Accordingly I favor a system of announced price floors and ceilings, executed by public purchases and sales through the authorized exchanges. The EPA should be entrusted with determining the collars, giving advance notice for review and possible disapproval by Congress, and the trades should be executed by the Treasury.

Thank you.