CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

Douglas W. Elmendorf, Director

May 21, 2009

Honorable Joe Barton
Ranking Member
Committee on Energy and
Commerce
U.S. House of Representatives
Washington, DC 20515

Dear Congressman:

You requested CBO's assessment of the budgetary impact of carbon emission allowances that would be distributed pursuant to the May 18, 2009, amendment in the nature of a substitute to H.R. 2454, the American Clean Energy and Security Act of 2009, currently under consideration by the Committee on Energy and Commerce. CBO received a copy of the amendment on Monday, May 18, and the staff is still analyzing the legislation for its full impact on the federal budget. However, CBO can provide some information on the budgetary impact of the carbon emission allowances that would be distributed under the legislation, elaborating on the more general description provided in the agency's May 15 letter to Chairman Waxman. This analysis is still preliminary and may change as more information becomes available.

The Budgetary Treatment of Emission Allowances

CBO's May 15 letter described the agency's view that the value of allowances—whether auctioned or freely distributed—should be recorded in the budget as both a revenue to the government and an outlay by the government. The cost of purchasing allowances, whether from the government or from other entities that might receive allowances, would become an additional business expense for companies that would have to comply with the cap on carbon emissions. Those additional expenses would result in a decrease in taxable income in the economy, which would result in a loss of government revenue from income and payroll taxes, offsetting an estimated 25 percent of the government's revenues from the allowances themselves.

Section 321 of the proposed legislation includes provisions to distribute some allowances to individuals and businesses at no cost. Depending on who would receive the allowances and what they would be used for, the reduction in taxable income mentioned above could be accompanied by a matching increase in taxable income elsewhere in the economy. If so, the added tax revenues would offset the initial loss of tax revenues from the sale of the allowances and make the net revenue from the issuance of the allowances equal to the value of the allowances themselves. In such cases, the issuance of the allowances would be budget neutral—that is, it would have no net effect on the budget deficit. In other circumstances, however, that would not be the result.

Allocations of Allowances to Businesses

In general, providing free carbon emission allowances to businesses—with no conditions regarding their use—would increase federal revenues and direct spending by equal amounts and would thus be a budget-neutral transaction. Allowances provided, under section 321, to merchant coal generators, generators with long-term power purchase agreements, and petroleum refiners all would fit into this category. Providing allowances to local electricity distribution companies also would be a budget-neutral transaction because the conditions placed on the use of those allowances by the proposed amendment would result in offsetting changes in federal revenues and direct spending.

Some—but not all—of the allowances provided to natural gas distributors would be budget neutral. As described in CBO's letter of May 15, allowances distributed with a requirement that proceeds be spent on cost-effective, energy-efficient measures (such as weatherization projects) would increase revenues by an estimated 25 percent less than the increase in direct spending, thus adding to projected budget deficits.

Allocations of Allowances to Nonbusiness Entities

In general, providing free carbon emission allowances to nonbusiness entities—such as to states to support specific activities, or to other countries to support efforts to reduce greenhouse gases—would not be budget neutral. Under the assumptions that govern budget estimates, the sale of allowances by those entities and their use of the proceeds would not create additional taxable income to offset the loss of taxable income that would result from the actions of those who purchase the allowances. For example, issuing allowances to states to finance projects to mitigate the impacts of climate change and to pay for developing energy-efficient building codes would not be budget neutral. In addition, CBO estimates that allowances provided to support establishment of Clean Energy Innovation Centers for research and development activities at universities and elsewhere would not be budget neutral.

Federal Spending of Auction Proceeds

CBO estimates that the federal government's spending of auction proceeds on certain programs specified in the bill—for worker assistance, mitigation of consumers' energy expenses, and certain climate change adaptations—would not result in additional tax revenues under the assumptions that govern budget estimates, and thus would not be budget neutral.

Sale of Future and Unallocated Allowances

Section 321 also would make some future allowances available for auction in earlier years. Specifically, in calendar years 2014 through 2030, packages of allowances consisting of one allowance from each year that is 12 to 17 years beyond the date of auction would be sold. Proceeds from such auctions would be deposited into the Treasury and available for spending subject to future appropriation acts. In addition, under this section, all carbon emission allowances that are not distributed or whose proceeds are not allocated for a specific purpose would be sold, and the proceeds from such sales also would be deposited into the Treasury. Although CBO is still analyzing the direct spending and revenue impacts of the entire bill, the advance sale of a sufficient number of allowances during the 2014-2020 period could offset the imbalance between revenues and direct spending in that period resulting from other provisions of the bill.

I hope this information is helpful to you. After the legislation has been ordered reported by the Energy and Commerce Committee, CBO will prepare a cost estimate as soon as possible. The CBO staff contacts for this letter are Mark Booth and Susanne Mehlman.

Sincerely,

for Robert A. Sunshine

Douglas W. Elmendorf
Director

cc: Honorable Henry A. Waxman
Chairman