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The Debate Zone: Carbon Tax V. Cap and Trade

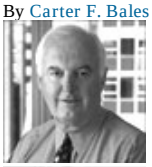
Why we need a carbon tax

By Gregg Easterbrook

It's simple. It's easy to enforce. And it provides the right incentives to polluters as well as inventors and engineers working to develop cleaner technologies.

Carbon caps are better

By Carter F. Bales and Rick Duke



A cap and trade policy gives business greater certainty about future costs. It also puts a limit on emissions and is more likely to result in a real reduction in greenhouse gases.

Ed. note: Our climate change debate engendered a lively conversation among readers that pushed the original essays well beyond their starting points.

Gregg Easterbrook

Why we need a carbon tax

It's a three-letter word that starts with "t," ends with "x." Go ahead, don't be afraid to say the word—"tax." The simplest, most efficacious, least bureaucratic, and best-for-the-nation initial move against greenhouse gas buildup would be a carbon tax.

This is not a liberal nostrum. Economist Martin Feldstein, once President Ronald Reagan's chief economic advisor, has been advocating a carbon tax for nearly 20 years. In 2007 N. Gregory Mankiw, former chief economic adviser to President George W. Bush, threw his weight behind the idea, saying that a carbon tax "may be the closest thing to a free lunch that economics has to offer." Here are the main arguments for a carbon tax:

Such a system would be far less complex than any cap-and-trade scheme. The McCain-Lieberman greenhouse gas cap-and-trade proposal, which drew 43 votes in the Senate in 2005, was 491 sections long. And that was just the authorizing legislation, not the tens of thousands of pages of administrative orders required to put the bill into force! The Obama plan is likely to be equally complex by the time it wends its way through Congress.

Because carbon cap-and-trade systems are inherently super-complex, they are nearly certain to be "gamed"—defeated by gimmicks, litigation, and special-favors lobbying. Lawyers will always think of pretexts faster than regulators can repair flaws in the language of complex regulation. America's approach to environmental regulation is already too steeped in litigation. A carbon cap-and-trade system would make this problem worse.

Whatever you tax, you get less of. Today America mainly taxes labor and capital—but we want more of both! We don't want more carbon, so let's tax that instead.

Owing to simplicity, enforcing a broad-based carbon tax is imaginable. Enforcing a broad-based carbon cap-and-trade scheme is hard to imagine.

If carbon is taxed, individuals—not government—will make the decisions about greenhouse-gas reduction strategies. Individuals have a *much* better track record at economic decision-making than government does.

Carbon taxes will offer a clear, easy-to-understand profit incentive to those who devise carbon-reduction technology—so inventors and engineers will get to work. Conversely, cap-and-trade programs will offer an incentive to game the system; so pollsters and lobbyists will get to work.

The only policy failure concern about a carbon tax is that individuals and firms will simply pay the tax rather than reduce emissions. This is possible, but unlikely: experience shows that individuals and firms change behavior to reduce taxation.

But isn't it totally and utterly politically impossible to enact a tax? Perhaps in the 1990s, when the federal budget was in surplus. Today the federal government is on the worst borrowing binge in its history—the national debt has doubled in a decade! Voters are not fools; they know little twinkling fairies will not come in the night to replace all the borrowed money. Debt must be repaid, and a carbon tax, which would create net benefits to society, may look a lot better to voters than other possibilities.

Back to top

Carter F. Bales and Richard D. Duke

Carbon caps are better

There are two main contenders for constraining carbon emissions: caps and taxes. Both are market-based approaches that put a price on carbon and other greenhouse gases and provide an economy-wide signal to encourage emission reductions, beginning with the lowest-cost opportunities.

The main difference between the two is that a pure tax fixes the price of carbon (but allows the amount of carbon emissions to vary) while a pure cap places limits on carbon emissions (letting the market price of tradable carbon allowances vary). We argue that a well-designed cap with certain tax-like features is the most efficient strategy to radically reduce emissions. This approach has four advantages.

First, a well-designed cap offers superior investor certainty relative to a tax because it establishes clear, long-term abatement requirements and allows the private sector to estimate the allowance prices needed to get the job done. In contrast, a carbon tax would likely start too low given political pressures and it would be exposed to unpredictable adjustments, as politicians would tend to raise or lower the tax in reaction to economic conditions. A well-designed cap should also include specific tax-like provisions.[1] Most important, the government should purchase and delete allowances if the price falls below a gradually rising floor.

Second, a cap on carbon provides more fundamental environmental certainty than a tax, because it is, by definition, a fixed limit on emissions and because the political process to define a cap is less likely to result in emissions loopholes. In particular, the political horse trading involved in defining a cap centers on distributing a fixed number of allowances—with equity and economic productivity implications but with no impact on future emissions levels. In contrast, negotiations to define a carbon tax might result in exemptions for certain sectors, which would allow higher emissions levels.

Third, once carbon caps are in place, all energy consumers share an interest in promoting complementary policies that reduce emissions. For example, all energy consumers will benefit from lower carbon allowance prices if they persuade policymakers to enact and enforce minimum energy efficiency standards for buildings, appliances, and vehicles.

Fourth, carbon caps provide a useful economic shock absorber, since allowance prices automatically soften as soon as the economy enters a recession. In principal, carbon taxes could also be adjusted frequently to make them more countercyclical, but to do this effectively would require an unlikely level of sophistication, objectivity, and alacrity on the part of policymakers.

Experience from the US cap-and-trade system for controlling the sulfur emissions that cause acid rain suggests that a well-designed approach can yield unanticipated cost-reducing innovations. If we do not take action immediately, greenhouse gas abatement costs will rise sharply.

[1] *See us-cap.org to download the Blueprint for Legislative Action, issued in January 2009 by 25 major corporations and 5 NGOs.*

Back to top