Enron Accounting: CBO and EPA Cooked the Books on Cost Estimates for Waxman-Markey Energy Tax

Later this week, the U.S. House will take up the Waxman-Markey global warming bill, the centerpiece of which is a cap and trade program that advocates argue will reduce U.S. greenhouse gas emissions. The bill features a remarkably aggressive timetable, one that would force businesses to cut emissions by 17% (relative to the 2005 baseline) by the year 2020, and by a cumulative 83% by 2050. On cue, "independent" agencies of the government such as CBO and EPA have announced cost estimates that grossly understate the burden Waxman-Markey will place on most U.S. households.

On June 19, the CBO announced that the cap-and trade program contained in Waxman-Markey would cost households an average of $175 in the year 2020 (measured in today's dollars). On June 23, in an effort to reassert its green bona fides, the EPA came out with an even lower estimate of $80-$111 per household. But even a cursory examination of the methodologies involved in manufacturing those numbers reveals that even the higher CBO figure is far too optimistic, since it leads citizens to believe that energy prices will only go up modestly because of the new cap and trade program.

In fact, very little related to the consequences of Waxman-Markey can be characterized as "modest." Households will pay far more than $175 per year due to cap and trade, notwithstanding CBO's attempts to hide it. The EPA study is misleading in the same fashion, but here we focus on the CBO report which can be read by the layperson and states quite clearly how it comes up with its low cost estimate.

Rags to Riches: How the CBO Transforms a Stealth Tax Into a Phantom Tax Cut

There are several major flaws with the CBO approach, but perhaps the most outrageous example of sleight of hand is the CBO's focus on after-tax income. Because Waxman-Markey will raise prices more than incomes, households will necessarily become poorer. This will push households into lower tax brackets—and thus have lower tax liabilities to the tune of roughly $8.7 billion. Normal people would consider this to be a downside of Waxman-Markey. CBO is not normal. It considers this $8.7 billion as an addition to total household income—money from heaven!—and goes about celebrating the effect of this policy without saying a thing about the cause.

1100 H Street NW · Suite 400 · Washington, DC 20005 · Phone 202.621.2950 · Fax 202.637.2420

www.instituteforenergyresearch.org

After explaining that some government benefits are indexed to the Consumer Price Index, which means that federal spending will have to *increase* owing to Waxman-Markey's energy price hikes, the CBO study points out the silver lining:

> *Because the federal income tax system is largely indexed to the consumer price index,* ***an increase in consumer prices with no increase in nominal incomes would also reduce federal income taxes.*** *That effect would increase households' after-tax income but would also add to the federal deficit. In combination, the effect of price changes on the government's indexed benefit payments and income tax receipts would convey an estimated $8.7 billion to households. (p. 7)*

Beyond the absurdity of translating rising prices into a benefit for households—on the basis that poorer people pay less in taxes—the CBO's treatment of income tax revenues is inconsistent with its treatment of carbon allowance auction receipts. The CBO study acknowledges that households will pay higher energy prices partly because businesses will "pass on" the cost of buying emission allowances. But CBO didn't include this component as a *net* cost to households, because the government *could* spend the auction receipts and thus recycle some of the money back into households.

But if that's how the CBO wants to do its accounting, then it can't credit households with a fictitious $8.7 billion "tax cut." As the quotation above points out, the falling income tax revenues will simply mean a *larger budget deficit* if the government doesn't cut other spending. This extra borrowing by the federal government will push up interest rates and transfer $8.7 billion out of the private capital markets. Households will ultimately lose wealth (in the form of greater public debt) that exactly offsets their alleged gain from falling into lower tax brackets.

Impacts on the "Average" Household

The CBO study admits on page 1 that the greenhouse gas (GHG) emission schedule would raise prices for Americans:

> *This analysis examines the average cost per household that would result from implementing the GHG cap-and-trade program under H.R. 2454….****Reducing emissions to the level required by the cap would be accomplished mainly by stemming demand for carbon-based energy by increasing its price….*** *Those higher prices, in turn, would reduce households' purchasing power. (p.1)*

However, the CBO's reported annual cost estimate of $175 per household in the year 2020, does *not* refer to the tallying up of the price hikes acknowledged in the quotation above. The CBO reduces the "gross cost" by mixing in all of the financial benefits that will accrue to "households" from the cap and trade program:

> *At the same time, the distribution of emission allowances would improve households' financial situation. The net financial impact of the program on households…would depend in large part on how many allowances were sold (versus given away), how the free allowances were allocated, and how any proceeds from selling allowances were used.* ***That net impact would reflect both the added costs that households experienced because of higher prices and the share of the allowance value that they received*** *in the form of benefit payments, rebates, tax decreases or credits, wages, and returns on their investments. (pp. 1-2)*

The problem should be obvious: If the government spends auction revenues, or hands out "free" allowances that possess high market value, to fund alternative energy boondoggles, the CBO study will carefully chalk that money up as flowing back into the pockets of U.S. "households."

The CBO's logic makes sense from a certain point of view: A firm that makes solar panels is owned by shareholders who live in houses, right? So when that solar panel firm sees huge profits in the new scheme, the wealth showered on its owners will accrue to households. Even though all electricity consumers will be paying higher prices, the "average" hit will be mitigated to the extent that some of those consumers happen to be on the receiving end of the cap and trade gravy train.

The CBO's reasoning may be appropriate in some applications, but it is grossly misleading in the current political context. Citizens may come away from the report believing that their annual expenses will rise only $175 because of Waxman-Markey. The real figure is much higher.

<u>The CBO's Gross Cost</u>

In contrast to the *net* cost of "$22 billion—or about $175 per household" (p.2), what does the CBO say about the *gross* cost, meaning the actual reduction in household purchasing power? In other words, how much of a hit will households take in the form of higher prices and lower wages, *before* the CBO adds back in all the pork spending and other goodies? They tell us on page 4:

> *According to CBO's estimates, the gross cost of complying with the GHG cap-and-trade program delineated in H.R. 2454* ***would be about $110 billion in 2020…or about $890 per household****…(p. 4)*

We see that the number reported in the press—"$175 per household by 2020"—represents only *20 percent* of the CBO's projected increase in household costs. The other 80 percent of the gross price hikes is transferred *away* from unlucky consumers and *into* the pockets of politically-connected beneficiaries. Since this wealth is redistributed, it's still in "households" (somewhere) and so the CBO doesn't report the gross figure, which is five times higher than the number bouncing around the press. But that's not the end of it. CBO didn't score anything but the "cap and trade" part of the bill…not the renewable energy mandate, not the additional costs of complying with the bureaucratic nirvana of new standards for energy efficiency of lighting for home art and "personal spas," etc. In some parts of the country, the "You Must Obey" renewable energy mandate could force significantly higher costs on consumers and businesses.

Winners and Losers

The CBO study acknowledges that its estimates are *average* figures, and that the impacts on particular sectors will be uneven:

> *The measure of costs described above reflects the costs that would occur once the economy had adjusted to the change in the relative prices of goods and services.* ***It does not include the costs that some current investors and workers in sectors of the economy that produce energy and energy-intensive goods and services would incur as the economy moved away from the use of fossil fuels****….Stock losses would tend to be widely dispersed among investors because shareholders typically diversify their portfolios. In contrast,* ***the costs of unemployment would probably be concentrated among relatively few households*** *and, by extension, their communities. (p.8)*

In addition to the negative impact on workers in energy-intensive sectors, the Waxman-Markey bill would also hurt energy *consumers* to different degrees, depending on which region of the country they lived in. The Southern and Midwestern states are much more reliant on coal and other fossil fuels for their electricity production. Consumers in these regions will see their electricity rates jump higher than in other areas of the country.

Conclusion

Make no mistake: Waxman-Markey is a tax that, to work properly, must find a way to drive up energy prices. CBO bends over backwards to try to disguise this fact, but even they admit Waxman-Markey will increase energy prices.

The CBO's gross cost estimate of $890 per household is also optimistic. Other studies put the figure at $1,500 per family in higher energy costs. That makes the much lower figure of $175 per household extremely misleading.

Bent on disguising the true costs of Waxman-Markey, CBO performed a deeply flawed analysis. They treat lower household income as a good thing because households will be subject to lower tax rates, even though this will increase the budget deficit and help drive up interest rates making economic growth more difficult.

The CBO is also disingenuous in its treatment of free allowances. The financial benefit of the free allowances will go to a small subset of the population (and to overseas investors), but CBO merely averages the benefits across the U.S. population. This is deeply disingenuous and misleading. Households are in for much bigger price hikes than the CBO would lead them to believe.

Despite CBO's heroic attempts to put a nice gloss on Waxman-Markey, cap and trade is what Rep. Dingell said it was—a tax, and a great big one.