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April 20, 2009

HOW TO USE EXISTING TAX AND BENEFIT SYSTEMS TO OFFSET CONSUMERS' HIGHER ENERGY COSTS UNDER AN EMISSIONS CAP

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This report outlines the Center on Budget and Policy Priorities' proposal to create a "climate rebate" for low- and middle-income consumers that offsets the impact of higher energy-related prices resulting from climate change policies. It also explains how this rebate could be delivered efficiently through the tax system and existing benefit systems.

KEY FINDINGS

- Climate change policies can be designed to offset the impact of higher energy-related prices on low-income and middle-income households.
- Consumer assistance should cover increases in households' various energy-related expenses, not just in their utility bills. It should be designed so it operates through proven delivery mechanisms and does not undercut incentives to conserve.
- The proposal presented here is designed to meet these tests. Low- and middle-income households would receive a "climate rebate." For most such households, the rebate would come via a tax credit. For veterans and Social Security beneficiaries, the rebate would come from the Department of Veterans Affairs or the Social Security Administration. Poor households that participate in programs such as food stamps would receive their rebate through the state agency that provides that assistance.
- This proposal would reach 95 percent of the people in the bottom income quintile and 98 percent of the people in the next two quintiles – and would do so automatically and efficiently, with no new bureaucratic structures and low administrative costs.
- An alternative approach – providing funds to utility companies to artificially suppress price increases in electric bills that would otherwise occur under an emissions cap – would undercut incentives to reduce electricity use. As a result, it would lead to larger increases in prices for *other* energy products than would otherwise occur, since the use of other forms of energy would have to decline still more to meet the emissions cap. The resulting inefficiency would place some burden on the economy and would fail to offset increases in energy-related costs other than home utilities.

Introduction

The Administration and Congress can design climate change policies to offset the impact of higher energy-related prices on low-income households — who are most vulnerable to these price increases — and middle-income households, who also will feel the squeeze.

Moreover, consumer assistance should cover increases in households' various energy-related expenses — not just in their utility bills, which will account for less than half of the overall hit to their budgets.

This consumer assistance is needed because policies that restrict greenhouse gas emissions will significantly raise the price of fossil-fuel energy products — from home energy and gasoline to food and other goods and services with significant energy inputs. Such policies, in turn, are necessary to encourage energy efficiency and greater use of clean energy sources.

Low-income consumers are the most vulnerable because they spend a larger share of their budgets on necessities like energy than better-off consumers do and because their budgets already are stretched. They also can least afford purchases of new, more energy-efficient cars, heating systems, and appliances. Protecting low-income consumers from increased hardship should therefore be a top priority in climate change legislation. Middle-income consumers, too, will feel the squeeze from higher energy-related prices, and policymakers have expressed interest in helping offset their added costs as well.

Fortunately, policymakers can design climate change policies to generate revenue sufficient to offset the impact of higher prices on the budgets of the most vulnerable households, to cushion the impact substantially for many other households, and to meet other legitimate public needs, such as expanded research on alternative energy sources.

As described below, policymakers can design a climate rebate to offset the impact of higher energy-related prices on low-income and middle-income households efficiently, by delivering the rebates through the tax system and existing benefit delivery systems.[1] The rebates would be funded with revenues raised by climate change legislation; under a cap and trade system, the revenues are raised when the government auctions emission permits.

We estimate that policymakers could "automatically" reach approximately 95 percent of households in the bottom quintile of the income distribution using these mechanisms, and with outreach this figure would go higher. We also estimate that policymakers could automatically reach more than 98 percent of households in the next two income quintiles. Because the rebates would build on existing tax and benefit delivery mechanisms, the approach would not require new bureaucratic structures, and the administrative costs would be relatively low compared with alternative delivery mechanisms. The size of the climate rebate and how far up the income scale it extends would depend on the amount of funding that policymakers make available for consumer relief and how much of consumers' losses they want to offset.

Guiding Principles

To offset higher costs for low- and middle-income consumers in a manner that is both effective and efficient, we recommend that policymakers follow six basic principles.

1. ***Protect the most vulnerable households.*** Climate change legislation should not make poor families poorer or push more people into poverty. To avoid that outcome, climate

[1] The design for a climate rebate laid out in this paper follows the same principles as earlier work on climate change policy by the Center on Budget and Policy Priorities, but incorporates the Center's latest thinking on how to reach as large a percentage of the target population as possible operating through existing, proven delivery mechanisms. For more discussion of the advantage of a rebate approach over other ways of providing consumer relief in climate legislation, see Chad Stone and Hannah Shaw, "Extending 'Climate Rebates' to Include Middle-Income Consumers," Center on Budget and Policy Priorities, February 19, 2009, http://www.cbpp.org/cms/index.cfm?fa=view&id=2650, and Chad Stone and Robert Greenstein, "Why Utilities Are Not Well-Suited to Deliver Relief to Low- and Moderate-Income Consumers in a Climate Bill," Center on Budget and Policy Priorities, February 19, 2009, http://www.cbpp.org/cms/index.cfm?fa=view&id=2649.

rebates should be designed to fully offset higher energy-related costs for low- and moderate-income families.

2. ***Use mechanisms that reach all or nearly all eligible households.*** Eligible working households could receive a climate rebate through the tax code, via a refundable tax credit. But many other households are elderly, unemployed (especially during recessions), or have serious disabilities and are not in the tax system. Climate rebates need to reach these households as well.

3. ***Minimize red tape.*** Funds set aside for consumer relief should go to intended beneficiaries, not to administrative costs or profits. Accordingly, policymakers should provide assistance to the greatest degree possible through existing, proven delivery mechanisms rather than new public or private bureaucracies.

4. ***Adjust for family size.*** Larger households should receive more help than smaller households because they have higher expenses. Families with several children will generally consume more energy, and consequently face larger burdens from increased energy costs, than individuals living alone. Various other tax benefits and means-tested assistance vary by household size; this one should as well.

5. ***Do not focus solely on utility bills.*** For low- and middle-income households, higher home energy prices will account for *less than half* of the total hit on their budgets from a cap-and-trade system. This is because goods and services across the economy use energy as an input or for transportation to market. Furthermore, about 20 percent of the households in the bottom quintile of the income spectrum — and many in the middle of the income spectrum as well — have their utility costs reflected in their rent, rather than paying utilities directly. Policymakers should structure climate rebates so they can help such families with the rent increases they will face as a result of climate policies, as well as with the higher prices that households will incur for gasoline and other products and services that are sensitive to energy costs.

6. ***Preserve economic incentives to reduce energy use efficiently.*** Broad-based consumer relief should provide benefits to consumers to offset higher costs while still ensuring that consumers face the right price incentives in the marketplace and reduce consumption accordingly. A consumer relief policy that suppresses price increases in one sector, such as electricity, would be inefficient, because it would blunt incentives to reduce fossil fuel use in that sector. That would keep electricity demand elevated relative to what it would be if consumers saw electricity prices rise and would place a greater burden on other sectors and energy services to provide the emissions reductions required under the cap. The result would be that emissions reductions would be more costly to achieve overall and allowance prices would be higher. Consumers might pay less for electricity, but prices would rise still more for other items.

The Climate Rebate: An Overview

To compensate for the effects that climate change legislation has on their purchasing power, households would be eligible for a climate rebate based on their household size. The rebate would be based on an estimate of the increased costs that households would face as a result of the reduction in carbon emissions. The rebate amount would vary by household size. (More details about how to set the rebate amounts are discussed below.)

We recommend that the rebate be delivered through three existing mechanisms, with appropriate coordination to ensure that people who both participate in a benefit program and file a tax return — and thus might qualify for a rebate through more than one delivery mechanism — receive the appropriate amount.

- **Most households qualifying for a rebate would receive it through the tax system.** For most households, a refundable income tax credit (i.e., one that provides a refund check to families whose tax credit amount exceeds their income tax liability) is the most efficient way to deliver a climate rebate.

  A tax-based system alone, however, would leave out a large share of households, particularly the lowest income households. According to the Urban Institute-Brookings Tax Policy Center, 15 percent of U.S. households do not file an income tax return (in most cases because they are not required to). Non-filers include seniors and people with disabilities who do not work and households headed by working-age adults who are jobless for some or all of the year, including some of the poorest families with children in the country.

- **Seniors, veterans, and people with disabilities who receive Social Security would receive their rebate as a direct payment from the federal agency that provides their benefits.** This is similar to the policy of direct payments to these individuals that was included in the economic recovery legislation enacted in February.

- **State human service agencies would deliver rebates to low-income families.** Households already participating in state human service programs such as food stamps, and other low-income households that choose to apply, would receive their monthly climate rebates through the state human service agencies that provide food stamps and other assistance.

Setting the Rebate Amount

The amount of the rebate would be based on the average hit to consumers' budgets for the group of consumers that policymakers decide should be fully compensated. So, if policymakers decide that low-income families should be fully compensated for their loss in purchasing power and middle-income consumers should be partially compensated, then the rebates could be set at the average purchasing power loss of households in the bottom fifth of the income distribution (varied by household size). If policymakers decide to use a larger share of the auction proceeds for consumer relief, they could set the rebate amounts at somewhat higher levels, such as the average loss to consumers in the middle fifth of the income distribution.

Under our proposal, the Energy Information Administration would be tasked with determining the annual rebate amounts. That could be done using an approach similar to the one followed by the Congressional Budget Office in estimating how the costs reflected in the total value of emissions allowances fall on families in different parts of the income distribution.[2]

For example, if the rebate were set at the average estimated loss in purchasing power to households in the middle quintile, and the emissions cap were set to achieve a 15 percent emission reduction relative to what emission levels would be without a cap, then we estimate that the annual rebates (in 2009 dollars) would be $700 for a household of one and $1,300 for a household of three.[3] (Due to economy-of-scale factors, rebates for larger households need not equal the rebate for a one-person household multiplied by the number of people in a household.)

Each of the rebate components, and the coordination mechanisms for ensuring that households are not over-compensated, are discussed in more detail below.

The Tax Component

Under this proposal, most households receiving a climate rebate would receive it as a refundable tax credit, which would be broadly available to low- and middle-income households. The credit would be available to anyone who files a federal tax return and whose income is below the eligibility limit set for the rebate; tax filers would simply look up the size of their credit in a table similar to the one used now for the EITC. Like other refundable tax credits, the climate rebate would phase in as income increased over some income range and then would phase out as income rose above a specified income level.

The tax credit would be provided annually when households file their tax returns. Alternatively (and preferably), the tax credit could be provided throughout the year as an adjustment to employer tax withholding, if possible.[4]

Most refundable tax credits are only available to households with earnings. For example, the partially refundable Child Tax Credit is not available to families whose Adjusted Gross Income (AGI) is within the eligibility range for the credit but whose income does not come from earnings. Policymakers may want to consider providing the climate tax credit to households that have income in the eligibility range but whose income comes in large part from sources other than earnings; this could be done by phasing the credit up at the bottom of the income scale as AGI rises, rather than

[2] Congressional Budget Office, "The Distributional Consequences of a Cap-and-Trade Program for CO2 Emissions," testimony before the Subcommittee on Income Security and Family Support, Committee on Ways and Means, U.S. House of Representatives, March 12, 2009.

[3] These are CBPP projections following a methodology similar to that used by CBO to estimate the distributional impact of an emissions reduction of this size. These estimates are based in part on past work by CBO and may be revised when CBO updates that work.

[4] If the tax credit is provided throughout the year via an adjustment to employer tax withholding, some elements of the rebate proposal described in this report would need to be modified. For example, low-income working families that also receive food stamps would not receive a rebate through the human service agency if their employer were adjusting tax withholding and providing the rebate through the paycheck. Despite such modifications, the basic elements of the rebate proposal would remain the same — workers would receive a tax credit, beneficiaries of Social Security and other federal programs would receive direct rebate payments, and very low-income families would receive rebates through state human service agencies.

The Making Work Pay Tax Credit and Climate Legislation

President Obama has proposed using the Making Work Pay tax credit enacted as part of this year's economic recovery package as the starting point for consumer relief in climate change legislation. A climate rebate could be built upon this tax credit. Under such an approach, at the point when climate rebate amounts exceeded the amount of the Making Work Pay credit, tax filers would be eligible for a "climate add-on" to the Making Work Pay credit to bring the total tax credit up to the rebate amount for their household size.

The current Making Work Pay credit is available to relatively high-income households; the credit does not fully phase out for married couples until earnings reach $190,000. To moderate the share of climate resources used for consumer relief, the add-on amount could be phased out at an income level that is not this high. For ease of tax administration, a single "look-up table" for both the Making Work Pay and the climate add-on would be used. Of course, a climate tax credit does not have to be built upon the Making Work Pay credit.

as earnings rise.

This would be particularly important to families in which a worker is temporarily unemployed and the family is relying on unemployment benefits or interest income from savings. Such a modification would ensure that more families would receive the credit during recessions, when the number of families relying on unemployment compensation increases.

In addition, as a result of climate change legislation and the normal dynamic nature of the U.S. economy, some industries are likely to contract while others expand as the economy shifts to a "greener" economy. Providing the rebate to individuals with income from unemployment insurance (or Trade Adjustment Assistance) would ensure that families that have lost jobs due to this employment shift do not lose out on consumer relief.

Direct Payments to Federal Beneficiaries

Among those most likely to be missed under the tax-credit delivery mechanism are lower-income seniors and people with disabilities who rely primarily on Social Security or other benefits and are not required to file income tax returns. To reach this group, the most effective policy would be for the Social Security Administration, the Department of Veterans Affairs, and the administrator of the Railroad Retirement program to provide climate rebates directly to people receiving Social Security, Supplemental Security Income (SSI), veterans', or Railroad Retirement benefits. Married beneficiaries would receive the climate rebate for a household of two; individual beneficiaries would receive the climate rebate for a household of one. The recently enacted economic recovery legislation calls for a similar payment to be made to these beneficiaries in coming months (as a one-time $250 payment).

We recommend that the payments to these beneficiaries be made quarterly so the beneficiaries do not have to wait for a once-a-year payment. Payments made more frequently than quarterly might be difficult to administer, since these agencies would need to match beneficiary data so they do not provide multiple rebates to individuals who are beneficiaries of more than one program.

Rebates Through the State Human Service Delivery Mechanism

The group that would *not* be reached through either a tax credit or direct payments from federal agencies such as the Social Security Administration would be very low-income households (primarily families with children) that have very low or no earnings over the year and do not receive Social Security or other similar federal benefits. Arguably this group is the most important to reach with a climate rebate, because the loss of purchasing power related to cap-and-trade legislation could push these individuals and their children deeper into poverty and create serious hardship.

The best mechanism to reach this group is to provide climate rebates through state human service agencies that already provide food stamp assistance, Medicaid, and other benefits to a broad array of low-income households. States could readily "piggy back" the climate credit onto the existing Electronic Benefit Transfer (debit card) systems that all states use to deliver food stamps and, in most states, other forms of assistance, including cash aid.

State human service agencies already have the infrastructure in place to gather information about families' incomes, evaluate eligibility, and issue payments through their existing EBT systems (which they use for food stamps) or another electronic payment mechanism. Delivering a climate rebate through existing state eligibility systems and delivery mechanisms would be far less costly to set up and administer than virtually any alternative. This mechanism also would ensure that the lowest-income families — the group that would be in the greatest danger of utility shut-offs and that generally has the most difficulty managing money — would receive their rebates on a monthly basis throughout the year.

The Food Stamp Program does especially well in reaching low-income families with children — 83 percent of eligible families with children participate. Poor households that do *not* receive food stamps but that meet the eligibility criteria for food stamps (income below 130 percent of the poverty line and limited assets) and wished to receive the climate change rebate could apply for the rebate through their state human services agency.

Coordination

The three-pronged delivery mechanism we recommend could result in some people qualifying for more than one climate rebate because they participate in one or more of the relevant programs and/or also file an income tax return. Accordingly, the following three coordination mechanisms would be employed to avoid overcompensation:

- First, state human service agencies would *not* provide climate rebates to individuals who receive Social Security, SSI, veterans' benefits, and Railroad Retirement benefits. Since the state agencies collect and capture detailed information on the sources of income for each household member for benefit eligibility purposes, they could readily adjust the rebates provided to these households through the EBT system to adjust for those household members who are receiving their rebates through these other programs.

- Second, at the end of the year, SSA, the Department of Veterans Affairs, and the Railroad Retirement agency would provide a 1099-type tax form to individuals to whom these agencies had made rebate payments and would also provide this information to the IRS. Payments received through the federal benefit programs would, on a dollar-for-dollar basis, offset any climate-related tax credit for which such individuals otherwise would qualify as part of a tax filing unit for that year.

- Finally, at the end of the year, state human service agencies would provide information to those adults who had received climate rebates through their state EBT system during the year. The information would show the number of months during the year that these individuals received climate rebates. (The same information would be provided to the IRS.) Households that file a tax return would be asked if they had received climate rebates through this mechanism, and if so, the number of months the rebates were received. Any climate-related tax rebate for which the household otherwise qualified through the tax system would be reduced proportionally based on the number of months that the filer and/or the spouse had received rebates through the EBT mechanism. For example, if the household head received climate rebates through EBT for six months, the tax unit's climate tax credit would be reduced by 50 percent.[5]

The coordination mechanisms we propose would require some new activities by state and federal agencies. Since the cap-and-trade policies would not become effective immediately and the emissions cap likely would be modest in the first couple of years, there should be sufficient lead-time to implement the coordination mechanisms effectively in the period between enactment of the climate legislation and actual implementation of the rebates.

Rebate Mechanisms Would Reach Nearly All Low- and Middle-Income Families

We estimate that about 95 percent of households in the bottom quintile of the income distribution would be reached automatically under this proposal, because they already receive SSI, Social Security, VA benefits, or Railroad Retirement, already participate in the Food Stamp Program, or already file an income tax return and have earnings. We estimate that more than 98 percent of households in the next two quintiles also would be reached automatically.[6]

All three of the delivery mechanisms outlined here would play a critical role in providing rebates to low-income families. Among households in the bottom quintile:

- About 50 percent would receive some or all of their rebate through SSA, VA, or the Railroad Retirement agency.

[5] We are proposing a different mechanism for adjusting the tax rebate for households that received rebates through the human service agencies — a proportional adjustment based on the number of months of rebate receipt — than the dollar-for-dollar mechanism used for those receiving rebates from SSA, the Department of Veterans Affairs, and the Railroad Retirement agency. This is to simplify the information that 50 state human service agencies must track and report to families and to the IRS.

[6] These estimates use Census Current Population Survey data for 2005 augmented by the Urban Institute's TRIM data, which account for underreporting of certain benefits. A modest fraction of low-income households might not receive the full amount of the rebate for which they qualify. This would happen if a household received a rebate through the human service agency for only part of the year and did not qualify for an additional amount through the tax rebate mechanism. Our analyses show that only 7-8 percent of low-income households would receive less than half of the full rebate amount.

- About 31 percent would receive some or all of their rebate through the EBT system their state human service agency operates.

- About 34 percent would receive some or all of their rebate through the refundable tax credit.

The EBT mechanism is particularly important for low-income families with children. About one-third of all low-income households with children would receive no rebate at all or receive only a partial rebate if this mechanism were not employed.