Washington's Carbon Experiment

by Michelle DeLappe


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This edition of Skookum Tax News analyzes and provides an update on several proposals Washington state is considering to reduce carbon emissions, including an agency regulation to set a cap on emissions and a ballot initiative to tax emissions.

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California has a carbon cap-and-trade program. British Columbia, Canada, has a carbon tax. Washington is ready to join those West Coast efforts to reduce carbon emissions, but no one knows what mechanism the state will choose. Washington is now considering a clean air rule that would cap greenhouse gas (GHG) emissions. In November, Washington voters may establish a carbon tax. However, the Association of Washington Business (AWB) argues that Washington businesses already lead the nation in protecting the environment and that a carbon cap or tax would negatively affect the state's small businesses and consumers.

Possibility #1: A Regulatory Cap on GHG Emissions

In 2009 former Gov. Christine Gregoire tried to persuade the Legislature to pass a cap-and-trade program.[1] In 2015 Gov. Jay Inslee (D) tried again, to no avail.[2] Inslee's plan labeled the state's oil refineries and other major industrial plants "major polluters" and would have required them to buy emission allowances in an auction for the region, in conjunction with British Columbia, Oregon, and California.[3] He expected the auction to raise nearly $1 billion in revenue annually.

Because those efforts failed, Inslee has moved at a breakneck pace on an alternative plan to cap and reduce GHG emissions. In mid-2015 Inslee tasked the state's Department of Ecology (DOE) with proposing a clean air rule by January 2016 and adopting a final one by summer 2016 after input from stakeholders. After meeting its deadline for issuing a proposed rule, stakeholders representing both industry and environmental concerns made it clear that the rule needed significant work. The DOE withdrew the rule in February and issued a revised proposal May 31. The public comment period on the new draft rule closed July 22.

The clean air rule, unlike the cap-and-trade proposal, would not have any centralized marketplace for trading emission allowances and therefore would not raise revenue for the state.[4] The updated rule "would require businesses and organizations that are responsible for large amounts of greenhouse gases like natural gas distributors, petroleum product producers and importers, power plants, metal manufacturers, waste facilities, and others to show once every three years that they're reducing their emissions an average of 1.7 percent annually."[5] Sarah Rees, special assistant on climate policy for the DOE, described the rule's strategic priority as slowing climate change by capping and reducing statewide GHG emissions under the state's existing Clean Air Act. The goal is to have reduced emissions to 1990 levels by 2010, to 25 percent below 1990 levels by 2035, and to 50 percent below 1990 levels by 2050. Businesses that do not sufficiently reduce emissions could comply by buying emission reduction units that businesses with extra reductions could sell.[6] The rule would use a special formula to try to address the needs of energy-intensive, trade-exposed industries in order to both target emission reductions based on comparisons with

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[1] Warren Cornwall, "Lawmakers Thwart Gregoire's Cap-and-Trade Plan on Climate," *The Seattle Times*, Mar. 16, 2009.

[2] HB 1315/SB 5283 (Carbon Pollution Accountability Act).

[3] Office of the Governor, "2015 Carbon Pollution Reduction Legislative Proposals," *available at* http://bit.ly/2bTrwt6.

[4] Office of the Governor, "Inslee Directing Ecology to Develop Regulatory Cap on Carbon Emissions" (July 28, 2015), *available at* http://bit.ly/2cpjzyn.

[5] Department of Ecology news release (June 1, 2016), *available at* http://bit.ly/2cpjKJT.

[6] Department of Ecology, "Frequently Asked Questions About the Washington Clean Air Rule," *available at* http://bit.ly/1RzQSxS.

national emissions for the particular industry and encourage the business to remain, and even expand, in Washington.[7]

Scott DuBoff, who practices law in environmental and energy matters at Garvey Schubert Barer, questioned how effective the rule would be: "Despite the commendable objectives of the Washington Department of Ecology's proposed Clean Air Rule, the state's proposal is in tension with, among other things, the fundamental reality that the problem to which it is addressed — global climate change — requires broad national and multinational solutions." Last week, DOE adopted the rule and declared that it will take effect October 17.

Possibility #2: A Carbon Tax

A similar goal drives Initiative 732, a citizen initiative backed by Carbon Washington, which describes itself as "a non-partisan grassroots group of individuals who are keen on bringing a BC-style carbon tax to Washington State."[8] I-732 would establish a carbon tax starting in 2017 at $15 per ton, with gradual increases to $100 per ton by 2059 (plus adjustments for inflation). I-732 would also reduce the state sales tax from 6.5 percent to 5.5 percent and reduce the business and occupation (B&O) tax on manufacturing from 0.44 percent of gross receipts to 0.001 percent. To help further offset the regressive effect of the carbon tax on low-income households,[9] I-732 would fund a working family tax rebate, which would provide a 25 percent match to the federal earned income tax credit.

The goal is a revenue-neutral measure. Greg Rock, an executive committee member at Carbon Washington, explained that its predictable pricing schedule over the next 40 years and offsets on other taxes reflect a "centrist policy" with the hope of attracting bipartisan support. By increasing the price of carbon emissions, Carbon Washington hopes to change behaviors at all levels of the economy — industries, investors, and consumers.

Whether I-732 would achieve revenue neutrality has sparked much debate. The Department of Revenue concluded in April that the measure would result in $800 million of lost revenue during its first five years in effect (revised from the $900 million loss the DOR projected in January).[10] The Sightline Institute, an environmental think tank, analyzed the DOR fiscal note and concluded, "I-732 is revenue neutral, to the best of anyone's ability to forecast it."[11] Sightline pointed to numerous difficulties in predicting the revenue effects of the various aspects of I-732 as well as several errors in the DOR's analysis.[12] Rock enthusiastically reported that Carbon Washington has experienced a "whirlwind of activity" since Sightline issued its analysis. He said he anticipates that the DOR fiscal note would be I-732's major hurdle at the polls. Most environmental groups oppose the measure largely because of its projected revenue loss. For example, the Sierra Club said it worries that losing revenue would put "already underfunded budgets for education, social services, and the environment at greater risk" and sees even Sightline's analysis as indicating a significant revenue loss.[13]

But another aspect of I-732 worries Drew Shirk, the DOR's senior assistant director of tax policy: how to implement the working family tax rebate. Washington does not have an individual income tax. Implementing the working family tax rebate would mean creating a computer database that the DOR does not have. The DOR fiscal note assumes that the state would need 60 or more full-time employees to administer I-732, a number Rock sees as exaggerated. Sightline did not examine that aspect of the DOR projection; the cost is small ($20 million) compared with other costs projected in the fiscal note.

Even if the measure achieves systemwide revenue neutrality, it would not be revenue neutral regarding many individual taxpayers. "Boeing will probably come out ahead," Rock said, whereas Ash Grove Cement Co., which burns coal to produce cement in downtown Seattle, has told Carbon Washington that it would come out behind. Rock admitted that Carbon Washington struggled to determine how to offset the carbon tax most effectively for manufacturers because it developed I-732 without access to companies' financial information. Also, some businesses previously eliminated their manufacturing B&O tax through legislative incentives for specific industries, such as food processing.[14] For those taxpayers, I-732 mostly represents an added cost. Still, Rock said that for the manufacturing sector as a whole, the tax reductions would fully offset the cost of the carbon tax.

Some manufacturers that perform in-state extracting activities, such as logging, may experience little or no relief

[7]Department of Ecology, "Energy-Intensive, Trade-Exposed Industries and the Clean Air Rule," *available at* http://bit.ly/2c5ksM7.

[8]Carbon Washington website, "Our Team," http://yeson732.org/our-team/.

[9]Natalie Chalifour, "A Feminist Perspective on Carbon Taxes," 22 *Can. J. Women & L.* 169, 194 (2010) ("While a carbon tax policy can be designed to mitigate regressivity, the whole *raison d'être* of carbon taxes is to raise the costs of goods and services based on their carbon content. The price increases that inevitably result from the tax will be harder on people with lower incomes than on those with higher incomes").

[10]Paul Jones, "Carbon Tax Initiative Revenue Neutral, Think Tank Says," *State Tax Notes*, Aug. 15, 2016, p. 528.

[11]Sightline Institute, "Does I-732 Really Have a 'Budget Hole'?" (Aug. 2, 2016), *available at* http://bit.ly/2aJTNFt.

[12]*Id.*

[13]Sierra Club Seattle, Aug. 23, 2016, *available at* http://bit.ly/2ckkXoi.

[14]Laws of 2015, ch. 6, 3d Spec. Sess. (among other things, extending a B&O tax exemption for food processors).

from I-732's virtual elimination of the B&O tax on manufacturing. That is because of the multiple activities tax credit, which is designed to minimize repetitive B&O tax on the same taxpayer for the same finished product.[15] Currently, a manufacturer can take a credit against the B&O tax on manufacturing for any B&O tax paid on extracting the products in the state. If the manufacturing B&O tax is practically eliminated, the business would still have to pay full B&O tax on its extracting activities, resulting in little to no change to offset that manufacturer's carbon tax burden.

Overall, Carbon Washington said it thinks that the offsetting reductions would encourage industries to remain in the state. And given Washington's abundance of hydroelectricity, which would remain untouched by any carbon pricing policy, Rock said that "businesses may flock to Washington because of its low-carbon energy" as carbon pricing efforts spread to other states. AWB's campaign against I-732 says the opposite, based on California's modest rate of growth in manufacturing since it established its carbon pricing policy through the cap-and-trade program: "If the carbon tax passes, companies looking to expand or move into a new market will simply decide to go elsewhere."[16]

Possibility #3: Both the Cap and the Tax

Though both Inslee and Carbon Washington want to reduce emissions, they strongly disagree about what mechanism would more effectively achieve that goal. Inslee said that a cap is the most powerful mechanism for reducing emissions. "If you go just the taxation route, the numbers you have to get to really change behavior and investment are not politically tenable," Inslee said.[17] But Rock argued that an early indication of the effects of a carbon tax show otherwise, because British Columbia's petroleum consumption per capita dropped 16 percent since the tax while the rest of Canada's petroleum consumption per capita increased 3 percent.

Neither the cap nor the tax would fund mitigation, adaptation, or preventive efforts regarding reducing pollution. I-732's carbon tax revenue would go to the state's general fund. According to Rock, that is based on the belief of most economists that carbon pricing is more effective than incentives for reducing emissions. Citing a lesson learned during his studies in sustainable energy engineering, he said, "It is always more effective to tax what you don't want than to subsidize what you do want." Carbon Washington does not oppose subsidies and targeted investments, but it sees carbon pricing as the more important step.

Inslee's emphasis on a cap suggests that, should he win a second term in November, he would implement the cap regardless of I-732's fate. But Rees, in discussing the clean air rule in May, said that would not be the case. She said that businesses would not have to contend with both the clean air rule and the carbon tax if I-732 passes. On the other hand, Rock said he sees no reason why a cap and a tax could not coexist. He explained that the tax is simply a mechanism to put a price on carbon emissions, similar to a trading mechanism through a marketplace like California's, and that a cap and a tax, even if operating separately, could be effective. Some have even contemplated the possibility of a cap-and-trade system combined with a carbon tax or with other tax elements, such as tax credits.[18] Still others have argued that a cap-and-trade program is the equivalent of a tax.[19] At this point, all options seem possible in Washington.

Possibility #4: Other Options

Through all this, AWB, while supporting the overarching goal of reducing carbon emissions, has argued that Washington businesses have already worked hard to make Washington one of the greenest states in the country. AWB is sponsoring a "No on 732" campaign based on the premise that "we should lead the world by continuing to reduce emissions through collaboration and innovation."[20] AWB has highlighted business efforts on that front for years, such as in its annual Green Manufacturing Award, which recognizes businesses that have "maximized energy efficiency levels, gone above and beyond regulatory requirements, minimized waste from the production process and reduced its carbon footprint."[21] Similarly, the Washington Business for Climate Action, a group of businesses, many of which are well-known leaders in the state, joined together in recent years around a declaration that supports businesses' voluntary efforts, such as investments in renewable energy, clean technologies, and energy efficiency.[22] That group has apparently taken no official position with regard to either the clean air rule or I-732.

A major concern with any environmental regulation is that the added costs could burden local businesses to the

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[15] RCW 82.04.440.

[16] AWB, "Campaign Launches to Defeat Proposed Carbon Tax" (July 21, 2016), *available at* http://www.noon732.com/news/.

[17] David Roberts, "The Greenest Governor in the Country Tells Grist About His Big Climate Plan," *Grist* (Jan. 13, 2015), *available at* http://bit.ly/1syriig.

[18] *See, e.g.*, David Gamage and Darien Shanske, "Using Taxes to Improve Cap and Trade, Part II: Efficient Pricing," *State Tax Notes*, Sept. 5, 2016, p. 807; Chalifour, *supra* 9, at 179; and David Suzuki Foundation, "Carbon Tax or Cap-and-Trade?" *available at* http://bit.ly/1Ny3cOu.

[19] *See, e.g.*, Jennifer Carr, "California Businesses Call Cap-and-Trade Auction an Illegal Tax," *State Tax Notes*, Apr. 22, 2013, p. 246.

[20] No on 732 website, "Why No on 732," *available at* http://www.noon732.com/what-we-do.

[21] AWB website, "Awards," *available at* https://www.awb.org/awards/.

[22] Washington Business for Climate Action website, *available at* http://bit.ly/2cdLy5f; and Ceres, "Washington Business Climate Declaration FAQs," *available at* http://bit.ly/2ckTwtU.

point that they cannot compete against businesses in locations where environmental laws are more lax, or that local businesses themselves move to those locations. Having a clean domestic plant that provides the local community with jobs and tax revenue is far preferable overall to importing products from a dirty or dangerous plant. Any measure to reduce emissions must ensure that it will not impair the competitiveness of the states' businesses. Both the proposed clean air rule and I-732 say they would avoid harm to Washington businesses. Regardless, though, some businesses would inevitably suffer under either regime.

Property taxes could also change as an unintended consequence of either regime. Companies that face increased burdens under the clean air rule or I-732 may, as a result, experience a change in the market value of their property. According to Chris Davis, Inslee's adviser on carbon markets, discussions of climate policy disregard that as a factor. But for companies whose products are inextricably tied to emitting carbon dioxide, the ultimate goal of those policies is an effect similar to that of Prohibition on a brewery or a distillery. Property specific to brewing beer or distilling alcohol would have naturally suffered extraordinary obsolescence when those products became illegal. That type of external force can produce a drastic decline in a property's market value and its assessed value for property taxes. Though often overlooked, that is one of the likely impacts under either the cap or tax scenario. Their effect on both carbon-intensive businesses and the communities that depend on the businesses' value for property tax revenue should be considered.

Conclusion

The carbon controversy in Washington is part of a much older debate: Should we use taxes to influence behavior or should we strive for tax neutrality in which only direct regulation and government subsidies regulate behaviors?[23] Tax systems routinely feature attempts to regulate behaviors: Sin taxes seek to reduce tobacco and alcohol use and Pigouvian taxes seek to charge those who engage in undesirable activities for the social costs they cause. Some argue that tax laws should serve as a mechanism for addressing "the externalities of the harmful effects of carbon, which the market does not take into account";[24] others contend that taxes should serve strictly "for raising revenue, not engineering whatever it is we're trying to engineer this week."[25] The bottom line, however, is that taxes and regulations can be effective in changing behaviors but can also impose costs on businesses and consumers.

Whether consciously or not, Washington voters will weigh in on this perennial debate in November. The state may tax carbon emissions or cap emissions by means of a new clean air rule — with the possibility of both at some point. Neither of those two mechanisms is intended to raise revenue for the state. But either way, some will face significant costs with the changes. ■

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[23] *See, e.g.*, Carlo Garbarino and Giulio Allevato, "The Global Architecture of Financial Regulatory Taxes," 36 *Mich. J. Int'l L.* 603, 610 (2014-2015).

[24] Patrick Dowdall, "Should a State Adopt a Carbon Tax?" *State Tax Notes*, May 30, 2015, p. 695.

[25] David Brunori, "Judge Not, That Ye Be Not Judged," *State Tax Notes*, Aug. 22, 2016, p. 639.