A SMART ENERGY POLICY:  
An Economist’s Rx for Balancing Cheap, Clean, and Secure Energy

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Goal of Energy Policy:
To Balance Cheap, Clean, and Secure Energy

But They are at odds with each other!

How do we balance the three?
The Current Situation: Cheap Wins

Fossil Fuels are the Bargain Fuel: Their Cost $P_0$ Sets the Playing Field

- **Secure**
- **Clean**
- **Cheap**
The Current Policy Approach:

Command and Control
+
Congressional Beauty Contests
Examples:

Tax Credits for Wind Farms
Subsidies for Bio-fuels

Solution: Let Congress pick winners and give subsidies sufficient to let the winners compete on playing field $P_0$
Congress Isn’t Very Good at Picking Winners

Congress

- Lacks Expertise
- Lacks Objectivity
- Forecloses other promising technologies
- True Cost is Not $P_0$

Miss Ethanol 20 Years Later
A Smart Energy Policy Levels the Playing Field at $P^*$ not $P_0$

AND Leaves it to market to determine the winners and losers!

Set $\text{TAX} =$

- Greenhouse Gas Externality
- Disruption Costs of insecure oil supplies
Proposed Carbon Tax:

Advantages:
1. Affects new infrastructure investments
2. Focuses changes in GHG in future
3. Minor macroeconomic disruptions today

A $5 CO₂ tax quintuples by 2050
But Isn’t Cap-and-Trade the Same Thing?

- Price Volatility prevents orderly transition
- Results in too high a price → Playing field > P*
- Subject to Political Manipulation

VS a TAX:
- Allows firms to plan their energy investments
- Playing field at correct price—P*
- Tax is transparent/no loopholes
Oil Security

The World Oil Market is one Big Bath Tub!

- Supply disruptions anywhere are felt by ALL

And NOT and a series of regional wash basins

- Supply disruptions are localized
Implications of the Bathtub:

1. Reject Petro-nationalism such as
   - Special Bilateral oil deals
   - Sponsoring state-owned oil companies to provide oil security

2. Reject Notions of Oil Independence
   - From Middle East Supplies?
   - From All foreign sources?
Oil Independence in Fortress America
3. Smart Policies

- See the World Market as a shock-absorber that spreads worldwide adjustments
- During Emergencies avoid price controls
- Encourage developing countries not to subsidize retail oil prices
- Adopt a $5/barrel Oil Security Tax/Encourage others to follow
It’s Simple and It’s Smart

Carbon and Oil Security Taxes set a new playing field

- Get Congress out of Beauty Pageant Business
- No subsidies or tax credits, Command & Control
- As new technologies unfold, let the market sort out the winners and losers, not Congress
- Continue to Support R & D
Overcoming Objections to the T Word

1. Make taxes “revenue neutral”
   - Offsetting income/payroll tax rate reductions

2. Explain that taxes
   - Will change the playing field
   - New technologies can thrive
   - Induce more conservation
   - Balances Cheap, Clean, and Secure

3. Magnitude of Initial Tax is not disruptive to Economy—future increases are gradual
   - Carbon Tax $ 37 billion
   - Oil Security Tax $ 36 billion
Is It Possible to Turn Cap-and-Trade into a Carbon Tax?

1. Auction off all Allowances—no freebies
2. Allow an Escape Valve Price at which Additional Allowances can be purchased from Government
   - Set Escape Valve at Carbon tax rate rising over time
3. Allow banking of Allowances from year to year
Thoughts on Waxman-Markey’s Cap-and-Trade

Good:
- At last we put a price on Carbon
- A new playing field on which new technologies can compete

Bad:
- Too much of a good thing $P > P^*$
- Price volatility will be very destabilizing
- Subject to political gaming—946 pages of special interests

Possible Fixes to Waxman-Markey:
- Auction off all allowances-no exception
- Set Safety Valve Price at my Carbon tax rate
  - Much slower transition away from fossil fuels
- Allow banking of allowances
- No special exemptions
- Make revenue neutral with healthy tax reductions