A critical question in climate debate

By Kristen Sheeran and James Barrett

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In all likelihood, the U.S. will soon implement a cap-and-trade system to reduce its carbon emissions. Such a system sets a maximum level of pollution that the nation could emit each year. The system would create a limited number of emissions rights or permits that would decline over time. For each ton of carbon a polluter emits, it would need to hold one permit. Polluters would be allowed to buy and sell permits from each other as needed.

While some thoughtful people oppose cap-and-trade systems for a variety of good reasons, they have one important economic feature: Economists widely agree that a well-designed cap-and-trade system can minimize the costs of achieving whatever emissions reduction target policymakers choose.

But a critical question remains: How should we get the permits into the hands of polluters? This may be the single most important climate policy decision made by this Congress.

There are two main mechanisms for distributing permits to polluters: awarding them free on the basis of past emissions levels (often called "grandfathering") or requiring polluters to buy them through an auction. The implications of grandfathering vs. auctioning permits are complex, but the economic answer to this question is clear and unambiguous: Permits should be auctioned.

The reason is that the effect on energy prices will be the same whether the permits are sold or given away. No matter how permits are distributed, polluters will not receive enough permits to cover their current pollution levels, so at least some of them will need to pollute less. Polluters who can do it cheaply will cut their emissions and sell their unused permits to polluters with relatively high abatement costs. In either case, someone, somewhere, will now have to either pay for a permit or pay to cut pollution. They will pass at least some of those production cost increases to consumers. And once one producer increases prices, the rest will follow suit. To do otherwise would be to leave money on the table.

Not convinced? Try buying World Series tickets from a scalper. Would he charge you any less if he found the tickets on the ground or got them free from a friend inside the ticket office? Of course he wouldn't. Like energy, the street price of World Series tickets is based on supply and demand. The supply and demand for tickets is the same no matter how much the scalper paid for them, and so the price he charges you will also be the same no matter how he got them.

Of course, the scalper would much rather get his tickets for free - and that's precisely the point. Polluters are financially much better off if permits are given away instead of auctioned, but the cost of cutting emissions and the resulting effect on energy prices will be the same no matter how the permits are delivered.

Giving permits away allows polluters to raise their prices without raising their costs. It would transfer hundreds of billions of dollars every year from consumers and businesses to polluters - energy companies and their stockholders. No wonder the energy companies are lobbying for grandfathered permits.

But the rich-get-richer distribution of wealth is not all that is at stake. Cap-and-trade systems and the associated higher energy prices, while effectively reducing pollution, can cause some drag on the economy, slowing job creation and economic growth. We can use revenues from auctioning permits to cut taxes and promote economic growth, invest in energy efficiency and create jobs, or put them to other productive uses. If permits are grandfathered, the economic effects of a cap-and-trade system end with higher energy prices and the problems that come with them.

The European Union has implemented a cap-and-trade system that has largely failed because it gave away almost all of the permits. As climate policy discussions heat up in Congress, we need to remember that how permits are distributed is almost as important as the emissions cap itself.

To prevent windfall profits for polluters, affirm the public's right to compensation for pollution and accelerate growth, climate policy should use cap-and-auction to reduce emissions.

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