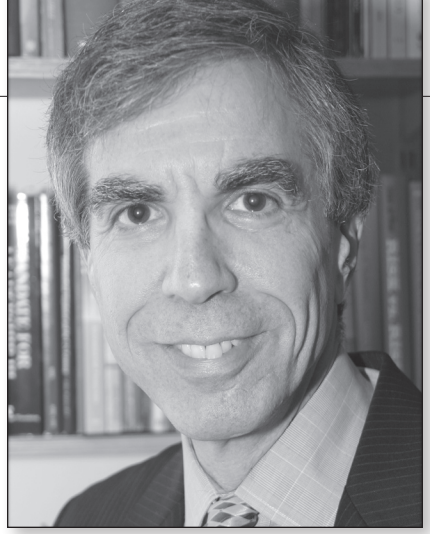

By Robert N. Stavins

Wonderful Politics of Cap-and-Trade

Despite all the hand-wringing in the press about a political "give-away" of allowances in the climate change legislation being considered in Congress, the politics of cap-and-trade systems are actually quite wonderful, which is why these systems have been used, and successfully.

The initial distribution of allowances — whether the allowances are auctioned or given out freely, and how they are freely distributed — has no impact on the allocation of allowances after trading, and therefore no impact on the allocation of emissions or emissions abatement, the total quantity of emissions, or the total social costs.

Firms face the same emissions cost regardless of the allocation method. When using an allowance, whether it was received for free or purchased, a firm loses the opportunity to sell that allowance, and thereby recognizes this opportunity cost in deciding whether to use the allowance. Consequently, the allocation choice will not influence a cap's overall costs.

Political pressures lead to different initial allocations of allowances, which affect distribution, but not environmental effectiveness, and not cost-effectiveness. This means that ordinary politics need not get in the way of developing and implementing a sound policy, a rarity in Washington. Contrast this with what would happen when pressure is brought to bear on a carbon tax proposal. Here the result will be exemptions of sectors and firms, which reduces environmental effectiveness and drives up costs (as some low-cost reduction opportunities are left off the table). Across the board, political pressures frequently reduce the effectiveness and increase the cost of well-intentioned public policies. Cap-and-trade provides protection from this.

The political process of states, districts, sectors, firms, and assorted interest groups fighting for their share of the pie serves as an effective mechanism whereby a political constituency is developed, but without detrimental effects to the policy's environmental or economic performance.

Some caveats are in order, because there are three ways that the choice to freely distribute allowances can affect a system's costs. First, auction revenue may be used in ways that reduce the costs of the existing tax system. Second, freely allocating allowances to electric utilities can affect electricity prices, and thereby the extent to which reduced electricity demand contributes to limiting emissions cost-effectively. Third, "output-based updating allocations" can drive up the costs of achieving a cap.

A useful, important, and fundamentally benign mechanism to garner support

Now, what about the claims in the press about a massive political give-away of allowances, suggesting that 75–80% of the allowances in the Waxman-Markey legislation, for example, would be given away to private industry as a windfall.

The best way to assess an allowance allocation is not as "free allocation" versus "auction," but in terms of the ultimate beneficiaries of the allocation and auction, that is, how the value of the allowances is allocated. In fact, most of the elements of the apparently free allocation in the Waxman-Markey bill accrue to consumers and public purposes, not private industry.

First, the share of allowance value in Waxman-Markey that will accrue to consumers and public purposes: electricity and natural gas local distribution companies 16.2%; home heating oil/propane, 0.9%; protection for low- and moderate-income households, 15.0%; worker assistance and job training, 0.8%; states for renewable energy, efficiency, and building codes, 5.8%; clean energy innovation centers, 1.0%; international deforestation, clean technology, and adaptation, 8.7%; and domestic adaptation, 5.0%.

Second, the elements that will accrue to private industry: merchant coal generators, 3.0%; energy-intensive, trade-exposed industries, 5%; carbon-capture and storage incentives, 4.1%; clean vehicle technology standards, 1.0%; oil refiners, 1.0%; and net benefits to industry as consumers of lower-priced electricity from allocation to LDCs, 6.0%.

All categories above sum to 73.5%, and the remaining allowances — 26.5% — are scheduled in Waxman-Markey to be used almost entirely for consumer rebates. Thus, the totals become 79.9% for consumers and public purposes versus 20.1% for private industry, or approximately 80% versus 20% — the opposite of an "80% free allowance corporate give-away." And this 80-20 split is roughly consistent with empirical economic analyses of the share that would be required — on average — to fully compensate (but no more) private industry for equity losses due to the policy's implementation.

The deal-making that took place in the Congress was a good example of the useful, important, and fundamentally benign mechanism through which a cap-and-trade system provides the means for a political constituency of support and action to be assembled, but without reducing the policy's effectiveness or driving up its cost.

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