Deciding the 'property rights' of emissions
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The Emissions Trading Task Group is due to report in May and the debate is taking shape. And while some issues are off the agenda - e.g. carbon tax but not emissions trading - interested parties are putting their views forward.

The Business Council of Australia has been, unsurprisingly and sensibly, quick off the mark in support of using the market to set the price of polluting as outlined in its paper, *Strategic Framework for Emissions Reduction*.

The market will be a powerful instrument in eliciting the right responses on carbon emissions, but there is a danger that market advocates might sneak some other issues past us under cover of their general advocacy.

The BCA submission does this. Even before there is any trading, there is the prior issue of who should have the "property right" to pollute. The BCA answer is to "issue free permits to compensate
enterprises for the economic loss from a change in the rules of the game".

There is an important distinction made here: it's not just the producers of polluting energy who will be adversely affected. Firms that produce goods which use a lot of energy (say, manufacturers of electric heaters) will also be hit by the switch in demand away from their product.

In practice we will all be adversely affected by price increases in the energy we use. The price rises need to be big enough to make us change our behaviour, so they must hurt if they are to work. So cutting emissions will be painfully costly for us all, and we need to decide, as a society, how to spread the pain and get to the new lower-emissions world as smoothly as possible.

This involves action on the supply side to find less-polluting ways of producing energy, and on the demand side by using less energy and switching consumption to less-polluting forms of energy.

We could give the valuable polluting rights to the firms most affected, as the BCA advocates, but why is their case stronger than that of the consumers of energy - who will go on bearing the cost, long after firms have had the opportunity to adjust their investment to restore their profitability?

This is largely an equity issue. The Coase theorem tells us that the initial allocation of pollution entitlements does not matter from the efficiency perspective, so long as they can be freely exchanged. This just says that if the rights can be traded, they will end up in the hands of those who have the highest-value use for them, whoever the beneficiary of the initial distribution was. It doesn't provide any guidance on who has the best claim to receive the allocation in the first place.

There is no a priori case for giving a favoured allocation to the producers most affected by the change in the rules of the game. After all, we haven't done that in the case of landowners who are now subject to bans on the right to clear their properties.

We could, for example, auction off the right to pollute to the highest bidder and use the proceeds to help compensate all losers, not just enterprises; or use the proceeds to give extra incentives for shifting to less emission-intensive production; or subsidise research into alternatives.

This sort of redistribution is hard to do fairly. The BCA has suggested that an independent board, such as the Reserve Bank board, could do the detailed job, but this is far more challenging and politically charged than the relatively simple technical job of setting interest rates.

One thing seems sure: giving all the pollution entitlements to the firms most affected is not the right answer.

Given that the task group has a clear majority of business members, the task ahead of the outnumbered bureaucrats on the group is formidable, so we need a broader public debate.

An alternative allocation is suggested by Warwick McKibbin (see *From National to International Climate Change Policy* on the Lowy Institute website), who proposes sharing (implicitly equally) the rights between corporations and households, in order to gain long-term political support for the continuation of the emissions regime.

Equity considerations might suggest a refinement of this: to give most or all of the short-term rights to the firms adversely affected (to compensate for their short-term transition losses as they move their capital to less pollution-intensive production) while the long-term rights go to consumers, who will bear the burden of higher energy costs forever.

This is not the only efficient and feasible solution: we need a considered debate to explore all the possibilities. We should look to the Emissions Trading Task Group to get us started on this process.

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