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Distributional effects of carbon-allowance trading

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Distributional effects of carbon-allowance trading

- Governments have the choice to either sell carbon allowances or to give them away (or a combination of both)
- In any of these options, the following criteria should be:
  - Economic efficiency
  - Environmental Improvement
  - Adaptability
- No one allocation approach is optimal but auctioning may significantly increase the cost of the program
- Auctioning therefore requires specific consideration to equity concerns/capital transfers and rent distribution
- It also highlights the need to ensure *adaptability* , defined here as coping with *international competitiveness and compatibility with international developments*

Equity considerations

- In any emissions trading scheme there are distributional issues between companies as to
  - Level of allowances received
  - Constraints on pass through costs by international competition
- Competitiveness concerns vary according to:
  - Sectors able to pass through costs
  - Exposure to competition from outside the system
- Allocation methodologies, through their specific incentive aspects, could balance the net drag on the economic performance of sectors
- But auctioning has a very significant distributional effect, depending on the recycling route used.

Means of addressing economic consequences

- **Allocation approach**
  - Hybrid portfolio approach
  - Ex-ante free allocation to offset impacts
  - Ex-post allocations to offset impacts
  - Revenue recycling
    - Installations/emitters
    - Consumers
  - Offsetting against taxation (labour, corporate taxes)
  - Lowering cap to sectors – governments pay for credit purchases (State aid)

- **Alternative policy options**
  - Reduce border competitiveness effects
    - Extending emissions trading globally
    - Border tax adjustments
  - Direct Investments in R&D and diffusion of new low carbon technologies

Rent distribution in the case of auctioning

- Where allowances are auctioned, significant revenues fall into the hands of governments
- As an initial allocation mechanism it runs the risk of significantly increasing the cost to industry
- Without “redistribution” these revenues are essentially the same as a tax
- Method of redistribution has a significant compliance cost and international competitiveness impact

Undesired effects of auctioning/recycling

- It is unlikely that "redistribution" would be as efficient as a market based approach in directing capital to the most cost effective projects and efficiency improvements
- Distributional impacts of auctioning on compliance cost vary significantly by sector and installation depending on the recycling route chosen.
- Cash outflows from installations to pay for allowances, erodes profitability, tax take and international competitiveness.
- Even if auction proceeds are recycled, there is a delay which has to be financed by installations via market prices.
- Auctioning delays the business response to compliance – waiting for auction price.

Conclusion

- Allocation methodologies need to address equity concerns in particular in a context of international competition
- If governments use auctioning they can use the revenue to reduce the costs that a cut in carbon emissions would impose on the economy
- The success of any auctioning recycling programme rests on the capability of governments to find better abatement opportunities for capital than the private sector.
- Other alternatives exist (e.g. a global regime) which should help industrial competitiveness

For more information

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