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Garnaut has got the compo right

There's no heart-melting case for free emission permits, **JACK PEZZEY** contends

Firms should not be given free emission permits as compensation when Australia's Emissions Trading Scheme is introduced in 2010 as a way to curb carbon dioxide and other greenhouse gas emissions by putting a price on them.

That's a message tucked away in the Garnaut Interim Report on climate change, issued last week, despite its claim that the distribution of climate change costs will be tackled separately midway through next month.

The report didn't actually say that no permits should be given free to business, and that all permits should be auctioned. Perhaps that's not surprising: initial permit allocation is a big deal, worth a lot more discussion.

Total permits could easily be worth $10 billion, or 1 per cent of GDP, every year. The exact value depends on the targets set for total emissions and permits, but targets are a separate issue from who gets the permits.

Professor Garnaut's message is in two dry paragraphs on whether any free permits should be given as compensation to "emissions-intensive" firms which are not "trade-exposed" – for example, to a typical coal-fired power station making electricity for Australians, but not an aluminium smelter producing mainly for export.

The Howard government task group's recommendation last May? "An up-front, once-and-for-all, free allocation of permits as compensation to existing businesses identified as likely to suffer a disproportionate loss of value due to the introduction of a carbon price." [Already much better than the European ETS's initial giveaway of almost all permits to big emitters like power stations, who promptly made windfall profits by passing on the permit costs as higher consumer prices.]

Professor Garnaut's view? "There is no tradition in Australia for compensating [businesses] for losses associated with economic reforms of general application [for example, general tariff reductions, floating of the currency or introduction of the goods and services tax] . . . the business community has been aware of the risks of carbon pricing for many years."

This must mean selling all the permits, rather than just some of them and giving the rest away free to selected businesses.

That's excellent advice – assuming the Government takes it – for both political and economic reasons, though firms who had expected the free permits will doubtless disagree furiously.

The political reason is that, as Professor Garnaut suggests, emissions-intensive, non-trade-exposed businesses don't meet the normal criteria for compensation.

Apart from the logic that any smart business should have seen emissions trading coming years ago, emissions trading is a "reform of general application": it affects almost all sectors of the economy, even if some much more strongly than others. No compensation was given for similar reforms in the past.

Where compensation has been given in Australia, it has generally been for policy reforms affecting the very livelihoods of small business owners in one sector of the economy, often concentrated in local communities, such as dairy farmers, irrigators and fishers.

The owners of businesses that will proportionally lose most from carbon pricing are quite different. Emissions-intensive firms are big businesses, mainly owned by shareholders, and almost all their largest shareholders are investment, superannuation and insurance funds, or state governments in the case of NSW electricity generators.

So any losses of business value will be shared among thousands of actual people – and mainly wealthy ones (the wealthiest fifth of households have two-thirds of Australian share ownership), and plenty of foreign ones (foreigners own a third of listed shares).

Hardly a heart-melting case for public handouts in compensation.

The economic reason is that free transfers of permits to businesses from government – you and me as taxpayers – are surprisingly wasteful, even if only 10 or 20 per cent of the total permit value is transferred.

First, that value not coming into government coffers means higher, incentive-sapping taxes: either an actual tax rise to pay for helping emission cutbacks, or a missed tax cut.

Second, and crucially, businesses and government will fight over one or two billion dollars per year of permit value.

Fighting, or "rent-seeking" in econ-speak, burns up costs for no benefit. Businesses hire consultants to argue with fancy economic models that their expected loss from carbon pricing is 100 megabucks, while government economists toil away and hire other consultants to argue that it's only 50 megabucks, or whatever.

And arguments inevitably mean costly delays in moving towards a lower-carbon society.

Just auctioning all the permits to the highest-value bidder is quicker, cheaper and fairer to the taxpayer.

Then we can argue about the best balance of spending auction revenue on necessary political and economic assistance – to poor households hit by higher fuel prices, to workers in affected businesses who don't get a cent out of free permits, to research into low-emission technologies, and to improvements in energy efficiency – all without blunting the price incentive to cut emissions that's the very purpose of the ETS.

Those are arguments worth having.

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