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AUCTIONING MARYLAND'S POLLUTION PERMITS

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The Environmental Protection Agency's new cap-and-trade program for nitrogen oxide emissions enables Maryland to improve its air quality while avoiding many of the negative economic effects of traditional air regulations. The EPA program also gives Maryland lawmakers a choice: distribute the program's emissions permits through a fair auction that could save taxpayers \$78 million a year without harming the economy, or give away the permits (and their \$78 million value) to politically favored businesses. Which will Annapolis choose?

Under a cap-and-trade program, the government first establishes a limit on the total amount of a pollutant that can be released. The government then distributes permits to firms that allow the release of specific units of the pollutant, and the firms can trade the permits between themselves. Taken together, the permits allow no more emissions than the government-established limit.

Cap-and-trade permits are more economically efficient than traditional regulations that force each firm to cut its emissions by a specified amount. A firm that can easily cut pollution will do so and sell some of its permits to a firm that finds it costly to reduce pollution. The program reaches its overall pollution control target, yet the trading flexibility provides substantial cost savings.

Cap-and-trade programs have become increasingly popular in recent years, largely because of the success of the national trading program for sulfur dioxide from electric utilities. That program, which

was part of the Clean Air Act Amendments of 1990, has reduced sulfur dioxide emissions from electric utilities by approximately 40 percent at a savings of about \$1 billion per year compared to conventional regulations.

That success has encouraged the EPA to try a similar program for nitrogen oxides. Under the new program, Maryland and 21 other states (plus Washington, D.C.) will distribute specified numbers of permits for the emission of one ton of nitrogen oxides each year. The states have discretion as to how they will distribute the permits.

Many states will simply give the permits to firms that have high emissions levels—and heavy political influence. But Maryland could opt for a more novel and economically sound approach and auction off the permits.

Firms likely would oppose the auction because they would prefer to receive the permits for free rather than pay for them. But auctioning permits would not impose a higher economic cost relative to giving away the permits. To understand why, consider this thought experiment: Imagine there is a cap-and-trade program for residential electricity use. If the government were to hand out the permits for free and you would receive some, you would still have to decide whether to use all of your permits yourself or cut your electricity usage and sell some of your permits to others. If, on the other hand, the government were to auction off the permits, you would have to purchase a permit for

every kilowatt of electricity you use. Either way—whether the permits are auctioned or given away—you have to decide whether to lose out on the market price of a permit in order to use electricity. The only difference between auctioning permits and giving them away is who gets the revenues—the state or the beneficiaries of the giveaway.

It might be difficult to believe that the government can raise revenues through permit auctions without imposing economic costs. The important point is that the stringency of the emissions cap itself restricts economic activity and thus imposes costs. Once the cap is decided, the means of allocating the permits only has a distributional effect. The EPA has already established Maryland's nitrogen oxides cap, so that cost cannot be changed; Maryland's only option is how to distribute the permits.

Given that auctions and giveaways have the same economic impacts, one could rightly ask why we should favor sending money to Annapolis rather than to individual firms. Without a doubt, nothing is gained if the state raises money that it then spends imprudently. That is why any decision to auction permits should be explicitly tied to uses of the resulting revenue that would improve the econ-

omy. For example, the revenue could be used to reduce economically harmful taxes such as Maryland's income tax, which discourages economic growth by creating a disincentive to work and save.

If Maryland were to auction all of the nitrogen oxides permits it receives from the EPA, it could expect to raise approximately \$78 million per year. In addition, the EPA is considering a cap-and-trade program for mercury emissions from electric utilities, and the states could auction those permits as well. Depending on the price of the permits, the mercury program could mean an additional \$13 million per year for Maryland once that program takes full effect.

In both the nitrogen oxide and mercury rules, the EPA is correctly leaving permit allocation decisions to the states, because those decisions will not affect the overall environment. Maryland should take advantage of this opportunity and consider using auctions as a means of raising revenue to reduce economically harmful tax rates.

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