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Reassessing the Importance of Initial Allocation Methods in Emission Permit Markets

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Author(s) Hintermann, Beat; MacKenzie, Ian Alexander

Author(s) at UniBasel [Hintermann, Beat](#) ;

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One of the most controversial aspects of a tradable permit market is the initial allocation of pollution permits. On the one hand, standard economic theory prescribes that the method of allocation does not matter, apart from second-order effects due to the possibility of reducing distortionary income taxes by recycling revenue from permit sales. Incentives for abatement, the market-clearing permit price and overall welfare should be the same regardless of whether grandfathering, auctioning or some other method is used to allocate permits. On the other hand, this prescription depends on a set of rather stringent assumptions. We discuss a number of departures from these baseline assumptions which cause the method of permit allocation to impact efficiency and/or overall social welfare, and all of which may be present to some extent in the world's largest emissions permit market to date, the European Union Emissions Trading Scheme (EU ETS). We critically analyze the evidence for using auction and grandfathering approaches in these situations. We show that the choice between grandfathering and auctioning crucially depends on many factors which include the specific type of grandfathering (e.g. pure grandfathering vs. allocation "updating", benchmarking, or output-based) and auctions (e.g. structure, use of revenue), the existence of market power and speculative uncertainty. Furthermore, we discuss the political acceptability of both approaches and explain, under policy implementation, which mechanism provides the highest social welfare. We provide an outlook on future issues and challenges and discuss other feasible alternative mechanisms.

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