Earlier this week California began auctioning off greenhouse gas emissions allowances, and the sky has not fallen. But is an auction really the best way to distribute the allowances? The California Chamber of Commerce says no. Its lawsuit—discussed in recent posts by Ann, Rhead, and Sean—doesn't challenge the State's authority to limit greenhouse gas emissions, or the selling and buying of emissions allowances. It doesn't challenge the "cap" or the "trade" in cap-and-trade. What it challenges is the auction. The Chamber says the State should give *all* of the allowances away to a lucky group, who could then use the allowances themselves or turn around and sell what they had been given for free. That proposal would probably strike most Californians as arbitrary and unfair. And they'd be right.

As Ann and Rhead point out, auctioning off the allowances doesn't turn the program into a "tax." And, for reasons that economists have long recognized, an auction is a particularly good way to get resources into the hands of the entities that value them most highly. They're the highest bidders for a reason. In the pollution control context, an auction creates an incentive for those who can reduce their emissions for less than the cost of allowances to reduce emissions. An auction also allows those with only costly options for reducing emissions to purchase allowances instead. Auctions aren't perfect, but when they're done right they have three key advantages: they are fair, efficient, and transparent.

Auctions are fair because they *avoid windfall profits*. The free allocation of allowances hands over valuable rights to lucky recipients at the expense of consumers and new entrants. Auctions let new entrants compete on the same playing field as older firms. When allowances are given away, existing companies, and inefficient companies (those who have not taken action to reduce emissions) are rewarded, while new companies, and companies that took early action to reduce emissions are penalized.

Auctions *allocate efficiently*. In theory, the "trade" part of cap-and-trade will wind up putting the allowances in the hands of the parties that value them most highly. If they don't get them in the initial distribution, they'll pay enough to get them in the emissions trading market. But as the financial crisis demonstrated, markets don't always work perfectly. Auctions put the allowances *at the outset* in the hands of the party that will pay most for them. And auctions make later trading more efficient, too, by creating what economists call a "price signal"—an indication of what should constitute a fair price.

Auctions are *transparent.* They make apparent to the public and to prospective purchasers the value of the allowances being distributed, and they help expose any hoarding by recipients.

In some ways the most remarkable aspect of the California Chamber of Commerce's lawsuit is what it doesn't say. It doesn't argue against a cap. It doesn't argue against the trading of emissions allowances. It just wants all of the allowances to be given away for free. That doesn't sound sensible, and it isn't.