**SUMMARY VERSION**

# TAX WASTE, NOT WORK

## How Changing What We Tax Can Lead to a Stronger Economy and a Cleaner Environment


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# INTRODUCTION

## BY PAUL KRUGMAN

Most sensible people are, with considerable justification, suspicious of policy advocates who promise too much. They know that, as a general rule, an offer that sounds too good to be true almost always is. If the proposal involves economics, they remember that they are not supposed to believe in free lunches. And anyone familiar with the fiscal irresponsibilities of the last two decades will be especially wary of enthusiasts promising miracle cures for our economic ills.



This monograph by Redefining Progress might therefore on the face of it seem suspect. It argues that a shift in the way we raise revenue—involving a partial replacement of taxes on earned income with taxes on pollution and waste—can not only protect the environment but make us richer, too. The monograph thus suggests that there is a free lunch that can kill two birds with a single stone—a prospect that may seem as unlikely as the metaphor is mixed. Tough-minded readers may be inclined to dismiss this as mere wishful thinking.

They would, however, be wrong. The details of the monograph can be, and should be, discussed and argued. But the proposal's general outline—replacing our current command-and-control system of environmental protection with one based on the price mechanism, and using the revenue from that system as a partial replacement for other sources of revenue—is not at all a silly or unrealistic scheme. On the contrary, it is sensible and important—and may well be an idea whose time has finally come.

To appreciate the reasonableness of what Redefining Progress has to say, it is important to understand that it is based on several well-founded propositions. First, measures to protect the environment—indeed, broader measures than we have instituted so far—are essential. Second, taxes (or other price mechanisms, such as the sale of pollution licenses) are in many cases the most effective way to implement such protection. Finally, since existing taxes already distort incentives to work, save, and invest, any revenue generated by pollution taxes that allows other taxes to be lower creates an extra "dividend" to the economy.

The proposition that it is important to protect the environment still has a few well-funded doubters. However, at this point the economic and human costs of pollution and other burdens on the environment, from the health effects of car exhausts to the collapse of overexploited fisheries, are by now too obvious for any but the most determined ideologue to ignore. And it is also obvious that our current system does not provide incentives for individuals to act in an environmentally responsible manner. For example, I bear hardly any of the indirect costs that I impose on other people by driving my car or eating a fish dinner. Some form of public action to

protect the environment against the consequences of the individual pursuit of self-interest is crucial.

Moreover, it has become clear in the last few years that the scope of such costs is wider than previously imagined. When environmentalism first became a powerful political force in the 1960s, most of the perceived problems were more or less local: They involved the quality of air in a given city, or the quality of water in a single river. As world population, production, and consumption grew and continue to grow, however, we see increasing evidence of human impacts on the global—as opposed to the local—environment. With the emergence of a scientific consensus on such issues as the adverse effect of manmade chemicals on the ozone layer or that of carbon dioxide and other greenhouse gases on global temperatures, we have reached a point at which decisions that made sense from an individual perspective may impose large costs not only on their neighbors but on humanity as a whole.

How can we best induce people to take the environmental consequences of their actions into account? There has long been an overwhelming consensus among economists that environmental problems should, in many if not all cases, be dealt with through a market mechanism—for example, that pollution should be limited either by taxing polluters or by auctioning off a limited quantity of pollution rights. Yet when America introduced national environmental regulation after 1970, this consensus was ignored: Environmental protection was based almost entirely on a top-down approach in which government agencies dictated specifics about production techniques, pollution control equipment, and so on, leaving little or no scope for individual initiative in meeting overall goals.

It was clear even at the time that this was a great missed opportunity—that although the environmental movement achieved significant successes, a market-based approach could have provided substantially more environmental protection at substantially less cost. With the shifting nature of our environmental problems, however, the case for a market-based approach has become much stronger. It is one thing to try to protect a river by regulating a small number of major point sources—say, by preventing chemical companies from dumping waste straight into the water or requiring municipalities to treat their sewage. It is quite another matter to try to limit the emissions of carbon dioxide, where such emissions are the result of hundreds of millions of individual decisions—whether to drive a small or a large car, to insulate a house or simply keep the heat up, to use coal or natural gas to generate electricity, and on and on. To figure out how these decisions should be modified is beyond the ability of any bureaucracy. However, a market-based incentive, such as a carbon tax, would put individual initiative to work on finding thousands of ways to reduce carbon dioxide emissions—purely as a matter of self-interest. And, in fact, the limited experience with market-based pollution controls to date suggests that, given flexibility, individual companies often find it surprisingly inexpensive to achieve pollution reductions that seemed very costly when imposed by rigid regulations.

Why has a market-based approach

to the environment been rejected for so long? A generation ago, many influential people were simply hostile to markets in general; furthermore, there was a tendency on the part of some groups to regard environmental protection as a moral issue, and thus to reject any proposal that seemed to say that it was all right to pollute as long as you paid the price. Meanwhile, conservatives have tended to oppose any policy, such as pollution taxes or the auction of environmental licenses, which might yield revenue, fearing that it would simply be used to expand government. Today, however, appreciation of the virtues of the market mechanism is much more widespread, and some environmentalist groups have actually begun to take the lead in proposing market-based approaches. At the same time, the authors of this monograph argue forcefully that fears about government expansion can be allayed by making the imposition of pollution taxes explicitly revenue-neutral, by linking the new sources of revenue to reductions in other taxes.



And this linkage is a benefit in itself. Taxes drive a wedge between the interests of the individual and those of society similar to that created by environmental issues: If I choose to work or invest less because I will be allowed to keep only part of any increased earnings, I reduce the revenue of the government and thus impose either higher taxes or lower benefits on everyone else. Proposals for tax reform are based on the notion that restructuring the way taxes are collected can reduce the size of this wedge without reducing revenue. But what if extra revenue can be collected from new taxes that, rather than distorting incentives, actually serve to bring individual and social interests closer together—such as pollution taxes? This revenue will allow a reduction in existing tax rates, producing a secondary gain from a reduced wedge between earnings and take-home income. This "double dividend" may sound like magic, but it is in fact no more than basic economics.

It is probably important to make clear that while there has been extensive discussion and debate over the double dividend, the central principle is not really in dispute. There is no question that if we regard environmental protection as essential—as we surely do—the cost will be much less if we use a market mechanism to implement that protection, and the cost will be further reduced if the revenue from that market mechanism is used to reduce other, distorting, taxes. Some economists go even farther and argue that a pollution tax will produce economic gains even if the benefits from reduced pollution are ignored—that is, that the cost of environmental protection is actually negative. Others dispute this. However, you need not accept this strong form of the double dividend argument to accept that market-based, revenue-yielding environmental regulation will produce large net benefits—and that because it will cost so much less at the margin than our current system, it is in our interest not only to adopt such a system, but to use it to protect our environment much better than we do at present.

It is probably safe to say that even a few years ago a monograph proposing such a policy change would simply have been ignored. Environmentalists were still too hostile to markets; many liberals were still attracted to bureaucratic

schemes of economic management; many conservatives were ideologically committed to the view that environmental problems were nonexistent, while others were too wrapped up in supply-side visions of self-financing tax cuts to be interested in other forms of tax reform. All those factions still exist. But right now ideologues of all stripes seem a bit shaken in their certainties, while the need to act seriously on global environmental issues is growing more obvious with each passing month.

In this monograph, we have a proposal that cuts across the normal ideological lines: it is pro-environment, but market-oriented; it takes supply-side concerns about the effects of taxes on incentives seriously, but proposes to meet them without counting on wishful thinking about economic growth. This kind of new thinking deserves attention; perhaps now is the moment when it will get it.

# EXECUTIVE SUMMARY

*Tax Waste, Not Work* offers a new approach to fiscal and environmental policy—a revenue-neutral shift to resource taxes or emission permits—which holds the potential to strengthen the economy, protect the environment, and encourage investment and savings—all in a way that could attract broad political support. The monograph provides a comprehensive analysis of the impact of shifting some of America's tax burden away from productive activities that should be encouraged, such as work and savings, and onto activities that should be discouraged, such as pollution, waste, and energy inefficiency.



*Tax Waste, Not Work* offers a blueprint for a tax system that reflects America's values and common sense. The report argues neither for higher taxes overall, nor a change in the distribution of the tax burden up or down the income scale. Rather, it offers a change in the way federal revenue is raised that would provide a rare opportunity to cut taxes on *both* labor and investment income, as opposed to one or the other.

A tax shift of this type could be accomplished either through the use of new taxes or through auctioned emission permits. But the central idea—that the new revenue should be used to reduce existing taxes—would be the same in either case. The proposal would replace a portion of federal revenues, perhaps 5 to 10 percent, with these new environmental levies.

This new approach to fiscal policy could create a novel alliance among those concerned with such seemingly disparate issues as:

- JOB CREATION: The payroll tax—a burden shared by workers and employers—has increased by nearly 25 percent since 1980, and it is now the largest tax for working families and most small businesses. A shift to resource taxes would allow for lower payroll taxes, which could lead to more jobs and higher take-home pay. Lower payroll taxes could also potentially provide a boost to job creation and economic opportunity in America's inner cities.

- ECONOMIC EFFICIENCY: Reducing taxes that carry large efficiency costs (e.g., the corporate income tax) could increase economic efficiency and improve the economy's overall capacity to create jobs and wealth.

- INCENTIVES FOR INVESTMENT: Businesses and individuals would gain new incentives to make investments in technological innovation, energy efficiency, or research and development.

- STRONG ENVIRONMENTAL PROTECTIONS AT LOWER COST: A tax shift could help address a host of environmental problems with a new generation of market-based solutions. Regulatory compliance costs could decline significantly.

- RESTORED FAITH IN THE TAX SYSTEM: The tax shift idea can restore legitimacy

to public finance by bringing a coherent rationale to the tax system: People should be able to keep more of the fruits of their toil, but should pay for the costs that they impose on others. If there is a consensus that taxing waste more and work less is reasonable, public trust in government and compliance with the tax system should increase.

A tax shift would provide a rare opportunity to cut taxes on both labor and investment income—an economic stimulus package with no revenue cost. Given the complexity of the recently-passed tax legislation, the shortcomings of the tax reform plans that have been offered, and the growing sense of urgency on the international level for addressing the threat of climate change, such a proposal could not come at a better time.

## WHAT ARE TODAY'S KEY PROBLEMS? (CHAPTER 2)

*High taxes on families and small businesses, and a tax system that needs reform*

The tax reform debate totally ignores the largest tax that working families pay: the payroll tax. A tax shift would make it possible to reduce this tax without endangering the government services it funds. Moreover, while fundamental tax reform is needed, each of the major reform proposals fails to address key issues, such as the economy's shift toward information- and technology-based industries. The recent proposals would also introduce new problems that a tax shift could avoid.

The recent tax legislation, while it did reduce income taxes for families with young children or students in college, failed to address the payroll tax issue.

*Environmental pollution, waste, and global climate change*

Regulatory approaches and end-of-pipe treatment systems are reaching their limits, especially when it comes to confronting new environmental challenges such as pollution from nonpoint sources, loss of biodiversity, and climate change. Climate change in particular involves potentially huge economic costs, and stabilizing the greenhouse gas emissions that are its primary cause will require some form of government action. Market-based approaches, such as taxes or permits, could provide strong environmental protection at much lower costs to society than traditional regulations. Other nations, from several Scandinavian counties to Costa Rica, are shifting to such mechanisms, and they make just as much sense for the United States.

There are other social and economic problems that a tax shift could help address, such as rising income inequality, changing labor markets, and the continuing decline of inner cities. These issues are also explored briefly in chapter 2.

## WHY A RESOURCE-BASED TAX SHIFT? (CHAPTER 3)



The case for a resource-based tax policy falls into three basic categories: civic and ethical, economic and fiscal, and environmental.

*Civic and ethical: Restoring legitimacy to public finance*

A tax shift policy would help restore legitimacy to public finance. The idea that people should keep more of their hard-earned income, but pay for the costs they impose on others, would provide a coherent rationale to the tax code that the current system lacks. Tax shifting also would draw more public revenue from resources "owned" by the public (e.g. federal lands, the broadcast spectrum), thereby enabling all citizens to receive dividends from the use of these assets. Finally, by providing incentives for investments in energy-efficient vehicles, homes, and equipment, a tax shift would enable people to reduce their own tax bills in a way that the current system does not.



*Economic and fiscal: Increased efficiency, lower taxes*

The economic and fiscal rationales for a tax shift rest on several pillars of mainstream thought. First, the current tax system imposes significant efficiency costs and slows economic progress. Replacing inefficient taxes with "corrective" ones could thus yield several benefits, ranging from more job creation and/or higher wages to more robust economic growth. Second, current market prices for many products do not take the social and environmental costs of production into account. To build such costs into the price system would remedy this problem. Third, the most efficient use of any revenues from environmental levies would be to reduce other taxes. It is this potential for lowering current taxes that will attract many individuals, businesses and elected officials to the tax shift idea.

*Environmental: Stronger protections at lower cost*

Industry leaders, economists, and environmentalists have shown growing support for market approaches to address environmental problems. Their focus has been not only on climate change, but also on pollution, congestion, and solid waste. The possibility of addressing these problems with less regulation creates the potential for important new alliances; economic growth and environmental protection need no longer be opposing goals. The tax shift idea also provides a new policy option for the United States as the next climate summit approaches in Kyoto, Japan in December 1997.

## WHAT ARE THE OPTIONS? (CHAPTER 4)

The tax shift idea means changing what is taxed and what is not taxed to encourage "goods" such as work and saving, and discourage "bads" such as pollution, waste, and energy inefficiency. Chapter 4 of *Tax Waste, Not Work* explains specifically what could be taxed and "untaxed" under a tax shift. The tax reduction options fall into five categories: (1) targeted reductions in the direct taxation of labor income; (2) targeted reductions in the direct taxation of capital; (3) reductions in general income taxes; (4) new tax credits and other tax incentives; and (5) tax simplification measures.

On the new revenues side, options include new taxes and fees, auctioned emission permits, and the repeal of environmentally harmful tax provisions. The options for new taxes and fees fall into

four categories: (1) taxes on energy consumption, of which taxes on carbon dioxide emissions and gasoline are the most prominent; (2) taxes on pollutants; (3) taxes on virgin materials, and (4) higher fees for using public resources.

### HOW MIGHT IT WORK? (CHAPTER 5)

The tax shift allows for broad flexibility in its implementation, and Chapter 5 describes four illustrative tax shift scenarios. Three of these involve replacing some portion of existing federal taxes with new taxes; the fourth uses auctionable tradable permits as the sole revenue source. In the permit scenario, the goal is to reduce greenhouse gas emissions to 1990 levels by the year 2010; the tax scenarios contain no explicit emissions reduction goal. In terms of magnitude, the largest scenario replaces 10 percent of federal revenue in the year 2002.

### WHAT ELSE DO WE NEED TO KNOW? (CHAPTER 6)

*Tax Waste, Not Work* does not suggest that a tax shift is a panacea, nor does it advocate immediate implementation. Many aspects of the proposal need further exploration. Chapter 6 highlights some significant areas for future research, including:

- Employment effects. Several European studies have shown that tax shifting can yield positive employment effects if the new revenues are used to reduce taxes on labor—Social Security contributions in particular. If these results can be replicated for the United States, this would have significant implications for job creation and urban economic development.

- Effects on business. The viability of any tax shift proposal depends in large part on how it would affect business. Therefore, detailed case studies of large companies are needed to better understand the possible implications on financial performance, investment decisions, site location, and other factors. Chapter 6 also includes a section on important international tax implications, such as border adjustability.

- Distribution of the tax burden. Past proposals for energy or pollution taxes have failed in part because of their likely distributional effects. This reflects the fact that taxes on energy or resources are typically regressive. But a tax shift need not be regressive if it reduces other regressive taxes. Further research should explore ways that a tax shift could be implemented without a general shift of the tax burden down the income scale.

Other topics discussed in chapter 6 include the potential environmental benefits of tax shifting, the need for new models to analyze better its economic ramifications, the effects on transportation policy, and the effects of a tax shift on inner cities. Finally, an appendix offers some pros and cons of other recent tax reform proposals and explains why none are ideal options for tax reform.

## WHY IT MAKES SENSE TO TAX POLLUTION INSTEAD OF WORK

### OUR VALUES: GIVING THEM A PLACE IN PUBLIC POLICY

#### RESTORING LEGITIMACY TO PUBLIC FINANCE

There is an urgent need to bring logic, coherency, and a reflection of public values into the tax code. By shifting some of the focus of taxation from "goods" like work to "bads" like pollution, the tax system would validate the public's sense that work and saving are good, and that wasteful consumption is not. Bringing a sense of logic and values back to the tax system could restore public trust in the political system at large.

#### PUBLIC DIVIDENDS FROM COMMON ASSETS

America has valuable stores of "common assets" that belong to all of us, such as the atmosphere and abundant natural resources. Free (or low-cost) use of these assets has led to many of the environmental problems the world faces today. A resource tax could work like an interest payment for the use of these assets, and the new revenues would provide a public dividend (i.e., lower taxes on work and saving) to which we all are entitled.

#### "TRUE-COST" ACCOUNTING

Americans place high value on a clean environment, yet current generations are leaving large environmental problems for future generations. If we were taxed based more upon the pollution and waste we create, rather than the incomes we earn, this would reinforce the notion that the costs of today's actions should not be passed on to our children. Such a tax shift would restore a sense of fairness, true-cost accounting, and "pay-as-you-go" government that the current tax system lacks.

### OUR ECONOMY: CREATING JOBS, ENCOURAGING GROWTH, AND INCREASING STABILITY

#### NEW INCENTIVES FOR JOB CREATION AND/OR HIGHER WAGES

The payroll tax has been rising steadily in recent years, which slows job creation and/or reduces wages. If reducing the payroll tax via a tax shift can produce either higher wages or more jobs, workers gain either way. Moreover, reducing the payroll tax could help move more low income workers into jobs—an important consideration in the wake of welfare reform.

#### MORE BUSINESS INVESTMENT—PARTICULARLY IN TECHNOLOGICAL INNOVATION AND ENERGY EFFICIENCY

New levies on pollution and waste will create a continuing incentive for businesses to innovate and find new technological solutions to environmental

problems. These innovations will cut the cost of pollution control and may also reduce the overall cost of production, thereby helping U.S. firms gain a competitive advantage. Moreover, a tax that raised energy prices would provide a powerful incentive to use energy more efficiently.

### CAPTURING NEW MARKETS AT HOME AND ABROAD

Developing countries are looking for creative ways to protect their environments and stretch limited natural resources as their economies expand. Thus, global demand for environmentally friendly goods and services will grow steadily. Firms and nations that devise the cleanest business practices for their domestic markets may be poised to capture these new export markets. A tax shift can speed up innovation and help U.S. firms capture new markets at home and abroad.

### OVERALL ECONOMIC GROWTH

Reconciling environmental and economic objectives is one of America's—and the world's—top policy priorities. Tax shifting may provide a "double dividend" by both enhancing environmental quality and stimulating economic growth by reducing taxes on labor and capital. There is debate within the economic community over this growth dividend; however, if the use of environmental taxes or permits can be shown to boost economic growth, the idea should take off.

### MORE SAVING AND INVESTMENT

Many economists believe that declining saving rates have contributed significantly to declining rates of growth in productivity, wages, and the economy since the mid-1970s. A tax shift could change the whole saving dynamic by changing the tax system's values and by providing a revenue cushion that would allow several new saving incentives to be tried at the same time. As a package, these proposals could have a significant effect on capital formation.

### GREATER ECONOMIC STABILITY

A tax shift could improve U.S. economic stability by reducing the nation's reliance on imported fossil fuels. The dependence of America's economy on cheap oil places the country in a potentially precarious economic situation since sudden changes in energy prices can have a great effect on U.S. economic performance. A tax on energy consumption should thus improve U.S. economic security by reducing overall petroleum use at the same time that it creates an incentive for new investments in conservation.

### MORE OPPORTUNITY AND JOB CREATION IN LOW-INCOME AREAS

The tax shift concept holds a potential for fostering economic growth in the inner city because it would augment the inherent economic advantages of cities: labor, materials, and location. A tax shift may help low-income areas in three ways: (1) by reducing taxes on work; (2) by spawning new enterprises based on recycling and reuse; and (3) by encouraging people to move closer to cities in order to cut down on transportation costs.

## OUR ENVIRONMENT: MORE PROTECTION WITH LESS REGULATION

### AVERTING LONG-TERM DAMAGE FROM CLIMATE CHANGE AND POLLUTION

Climate change. Most scientists believe that continued high releases of greenhouse gases will have detrimental effects on the planet. Costly consequences may include a rising sea level, a shift in the competitive balance among species, the spread of tropical diseases, more severe weather patterns, and, as a result, more frequent political crises. Reducing carbon dioxide emissions—primarily through reductions in fossil fuel use—is the surest way to slow climate change.



Pollution. Despite advances in pollution abatement, air and water pollution still carry high costs in terms of human health, effects on animal species, damage to structures, and reductions in tourism. A shift to resource taxes can help reduce the incidence of these continuing problems.

### MORE EFFICIENT USE OF PUBLIC RESOURCES

The absence of an efficient tax on using "common assets" causes public resources to be overused. A resource tax filters out low-value uses of these resources, leaving more room for high-value activities. For example, by imposing a small fee on auto use during peak hours, some trips will be diverted to less congested times. A tax shift would allow this same philosophy to apply to other resources such as inland waterways or national parks, thus making their overuse less likely.

### EFFICIENCY IN POLLUTION CONTROL

Market-based approaches work through the price system to allow firms and individuals to find the cheapest way to achieve the goal of conservation, instead of requiring each polluter or other resource user to cut waste in exactly the same way by exactly the same amount. By using prices instead of mandated standards to reduce undesirable activities, companies can save millions of dollars on regulatory compliance, which they can then spend on new workers or investments.

## OUR TAX SYSTEM: MAKING IT SIMPLER AND MORE EFFICIENT

### REPLACING ECONOMICALLY INEFFICIENT TAXES

Taxes on labor and capital distort economic choices and can slow economic growth. Some economists believe that a tax on pollution, carbon dioxide emissions, or waste would correct existing problems and reduce these economic losses. If a tax shift reduced the economic costs of the tax system, then billions of dollars in previously "lost" resources would become available for additional consumption, saving, or investment.

### THE BENEFITS OF SIMPLIFICATION

Greater simplicity would reduce the time and resources spent on income tax compliance. Simplification within the context of a tax shift would prevent deficits from rising, due to the additional revenue generated from taxes on pollution or greenhouse gas emissions. Greater tax simplicity would allow families and firms to spend less time and money on tax preparation.

# CHAPTER 1
## AN IDEA WHOSE TIME HAS COME

Despite many recent improvements in the American economy—such as a high rate of job creation, declining deficits, and low inflation and unemployment—the nation is still struggling with several important long-term problems.

Among the most serious of these are the payroll tax and the exploding growth of entitlement programs; the emergence of global climate change as a significant environmental and economic threat; the lack of economic opportunity in our inner cities; and the dislocation and hardship that are being caused by major economic transformations (such as the rapid growth of information technologies) even as they provide exciting new opportunities. Each of these problems has caused many scholars and activists to look for solutions, but so far few good ideas have moved from theory to actual policy.

### A FRESH APPROACH TO SOME OLD QUESTIONS

The premise of this monograph is that a new approach to fiscal and environmental policy—a resource-based tax shift—holds the potential for improving many of the country's problems simultaneously, while attracting support across the political spectrum. This approach would reduce current taxes on labor, innovation, and capital formation and replace the revenue with new levies on pollution and waste. Total federal revenue would be unchanged and the current distribution of the tax burden across income groups would be preserved.

The proposed new tax system is designed to be revenue- and distributionally-neutral because the way in which a free society decides to distribute the burden or spend public tax dollars should be a separate issue from that of the method used to raise the revenue. This distinction is not meant to be an endorsement of the current tax distribution or size of government. Rather, it is meant to emphasize the fact that the tax shift is neither a tool to increase government (in fact, it could do just the opposite), nor to shift the tax burden to the rich or the middle class.

A revenue-neutral tax shift of this type could be accomplished through the use of new taxes or tradable emission permits, but the central idea—that the new revenue should be used to *reduce* existing taxes—would be the same under either mechanism. Many of the potential benefits of this policy idea are dependent upon this "revenue recycling." Because other taxes are being reduced, this proposal is *not* a new revenue source to buttress government expenditures. It would simply replace a portion of federal revenues—perhaps 5 to 10 percent—with revenues from environmental taxes or permits.

This new approach to public policy could create an alliance among those concerned with problems such as high taxes on capital formation or on the average family; the need for additional investments in human capital and research and development; the threats to the global environment; the costly regulatory burden on private industry; rising public debts; the complexity of international tax rules; and job creation in inner cities. It would provide a rare opportunity to enact tax cuts on both labor *and* investment income. By so doing, it would attract support from both ends of the political spectrum and potentially create incentives for more investment in both human *and* physical capital—an economic stimulus package with no revenue cost. Given the mounting interest in fundamental tax reform, the weaknesses of the tax reform plans that have been offered, and the growing international momentum for addressing the threat of climate change, such a proposal could not come at a more opportune time.

**The current tax system sends the wrong signals to virtually everyone. It discourages work, enterprise, and capital formation while it encourages sprawl, pollution, waste, and the inefficient use of resources.**



## THE TAX SHIFT CONCEPT

The current tax system sends the wrong signals to virtually everyone. It discourages work, enterprise, and capital formation while it encourages sprawl, pollution, waste, and the inefficient use of resources. There is almost unanimous agreement that the tax system needs reform.

There are really two sides to the tax reform debate—and they aren't "liberal" versus "conservative." Rather, they are what should be taxed and what should be *un*taxed, and the next attempt at major tax reform should focus on both. Look at it this way: When the government wants to promote a social goal, what does it do? It reduces income taxes—via credits, preferences, and deductions—on particular activities that the government thinks will help accomplish that objective. Retired Sen. Bill Bradley (D-NJ) calls this practice "government by tax break," and it helps explain why the tax system is the part of government that people hate the most. But what if the government can accomplish social goals *both through what it taxes as well as what it untaxes?*

Common sense dictates that you get less of what you tax and more of what you don't. Since higher rates of saving and investment can drive faster economic growth, many recent tax proposals focus on reducing taxes on capital income in the hopes of creating more saving and investment. Yet in an effort to keep total revenue relatively stable, some of these proposals would *increase* taxes on labor in order to *untax* capital. This action would have the perverse result of raising taxes on modest and average income people—and if common sense applies, this in turn would result in *less* labor.

The argument works the other way as well: Higher taxes on capital holders should not be used to finance tax cuts for working people, because these tax increases penalize the investment and entrepreneurism that creates new jobs and opportunities. Such a policy untaxes labor in order to tax

capital. In an economy that needs more of both human and physical capital, considering tax cuts on only one or the other presents a false choice.

Make no mistake: A tax code is primarily a means of raising revenue. But it also sends powerful messages through what it does, and does not, tax. In this light, why not develop a socially useful tax system that would tax those things the country needs less of, and untax those things of which society wants more? This idea is being tried around the world, and even the British news magazine *The Economist* has endorsed such an approach. This monograph suggests bringing this concept, commonly called environmental or resource-based tax shifting, to the United States.

This type of tax reform could lead to a cleaner environment at the same time that incentives are provided for more work and investment. Just as important, it could be designed without a regressive shift of the tax burden if regressive taxes like the payroll tax are reduced to offset the new levies. Revenues could be gained from taxing carbon dioxide emissions, air and water pollution, or consumption of virgin materials. Emission permits could be auctioned to firms, which would also raise substantial revenue; similarly, fees could be charged for the use of certain assets held in common by the public. On the tax reduction side, payroll, individual, and corporate tax rates could all be reduced—without increasing the deficit or forcing huge cuts in government services.

While such a shift from taxing "goods"—the creation of wealth through labor and investment—to "bads"—the depletion of wealth through pollution and environmental degradation—cannot be a panacea for every economic and environmental ill, it does offer a promising chance for promoting work and investment while concurrently moving toward the types of market-based policies that would be an improvement over the current regulatory structure.

## DEFLECTING PAST CRITIQUES

The idea of using market-based policies such as taxes or emission permits to deal with environmental problems has been a staple of the academic literature for decades. But these policy tools have been widely criticized in the United States for a number of reasons—all of which a tax shift would address:

- Environmental taxes and permits have often been pushed as tax *increases*, rather than as a lever for reducing other taxes. A tax shift, however, would substitute higher taxes on some things with lower taxes on others, with the objective of leaving most individuals paying roughly the same amount in total. Only recently has this idea for "revenue recycling" been receiving attention from academics and public policy groups. For example, the World Resources Institute's *Green Fees* report and Ernst Ulrich von Weizsacker's book, *Ecological Tax Reform* (both published in 1992), broke new ground in this area; an interesting body of literature has followed these front runners, discussing the potential benefits of such "recycling."

**In an economy that needs more of both human and physical capital, considering tax cuts on only one or the other presents a false choice.**

- The business community has lobbied against these so-called "green taxes" in the past, fearing that they would cost jobs, reduce economic growth, or detract from U.S. competitiveness. But a tax shift, by reducing other taxes with high distortionary costs, should greatly reduce or eliminate these concerns.

**A tax shift policy sends a powerful message from the perspective of restoring legitimacy to public finance: Individuals should be able to keep more of the fruits of their toil, but should pay for the costs that they impose on others.**

- Environmental taxes and permits have been criticized for their regressive nature—that is, for affecting the poor and middle classes relatively more than the well-off, since lower income families spend a larger percentage of their income on energy. Yet under a tax shift, other regressive taxes—such as the Social Security payroll tax—could be reduced to maintain the current distribution of the tax burden.



- Past critics could point to the potential risk of being the first industrialized country to advance these proposals in a major way. But now there are models to look to, as several countries *have* adopted "green taxes"; and others, including Denmark, Great Britain, and Costa Rica, have passed mild tax shifts.

## THE RATIONALES FOR CHANGE

### PHILOSOPHIC RATIONALES

A tax shift policy sends a powerful message from the perspective of restoring legitimacy to public finance: Individuals should be able to keep more of the fruits of their toil, but should pay for the costs that they impose on others. This change would restore both a coherent rationale and a sense of values to the nation's tax system. Tax shifting also offers the potential to draw public revenue from resources already owned in common (e.g., public lands, the broadcast spectrum), thereby enabling all citizens to receive dividends from the use of common assets.

To the extent that it replaces the current tax structure, a shift to resource taxes would also restore the notion that the costs of today's actions should not be borne by future generations. This would bring a sense of "honest accounting" back to government. In other words, rather than paying taxes based upon their work or saving, people should increasingly pay taxes based upon the resources they consume and the pollution they cause. Thus, society "pays" for the problems it passes on to its children.

Finally, by providing incentives for people and businesses to invest in energy efficient vehicles, homes, and equipment, a tax shift empowers people to reduce their own tax bills in a way that the current system does not.

### ECONOMIC AND FISCAL RATIONALES

While tax shifting is a relatively new idea, the economic rationales for pursuing it are numerous and rest on several long-standing pillars of mainstream thought.

- The current tax system imposes significant efficiency costs and therefore retards economic growth. Replacing a portion of these economically inefficient taxes with "corrective" taxes (which have lower efficiency costs, or "deadweight losses") could reduce the overall economic cost of the tax system. It could also yield several important eco-

nomic benefits, ranging from more job creation and/or higher wages to new investments in energy efficiency and higher economic growth. Whether a tax shift could yield these gains is a vibrant new area of economic research.

- Current market prices for many goods do not take the social and environmental costs of production or energy consumption into account. Adding the costs of these externalities into the price system, via the tax code or emission permits, would make the economy more efficient. Despite disagreement about how (and by how much) energy prices ought to be raised, most economists would agree that energy prices ought to be higher—and that higher prices would not be as costly to the economy as some critics claim.

- The academic literature has shown that the most efficient use of any revenues from environmental levies would be to reduce other taxes. While there is disagreement over whether tax cuts on work or investment are more likely to yield economic gains, it is this potential for lowering current taxes that is likely to be the most appealing part of this proposal for many individuals, private firms, and elected officials.

### ENVIRONMENTAL RATIONALES

Another motivating force for a tax shift is that it would provide a least-cost approach to reducing pollution, waste, and the long-term threat of climate change. In the summer of 1995, the Intergovernmental Panel on Climate Change (IPCC)—a group of more than 2,200 scientists and economists from nearly 60 nations—declared that "the balance of evidence suggests that there is a discernible human influence on global climate," signaling the growing scientific consensus on the issue.

The view that climate change is not an economic problem is changing as the staggering costs of dealing with its effects become more apparent. Despite greater energy efficiency in the United States, global emissions of carbon dioxide are projected to grow by 54 percent over the next 20 years. In response, the U.S. government has begun to shift its view of the climate change problem. In fact, in July 1996, the Clinton Administration announced its support for the adoption of binding yet flexible targets to reduce global carbon emissions. This announcement was a major new policy commitment, and it has already drawn a considerable amount of political and media attention as the next United Nations Conference on Climate Change—scheduled for December 1997 in Kyoto, Japan—approaches.

Industry leaders, members of Congress, academic economists, and many members of the environmental community have also shown growing support for market-based approaches to environmental policy. For example, various business sectors—most notably insurance and finance—are increasingly viewing climate change as a threat to economic performance, public health, and geopolitical stability. The focus of these interests has not only been on the climate change issue, but also on pollution, congestion, and solid waste. The possibility of addressing these problems with less regulation creates the potential for new alliances between business, environmentalists, labor unions,

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tax reformers, and elected officials at all points along the political spectrum.

## THE POTENTIAL BENEFITS OF CHANGE

The following are the most important potential benefits of this fresh approach to fiscal policy, each of which is examined in this monograph.

1. Job creation could be spurred, take-home pay increased, and / or incentives to enter the workforce enhanced as a result of lower payroll taxes.

2. Economic efficiency could be enhanced by reducing taxes that carry large efficiency losses, thus improving the economy's overall capacity to create jobs and wealth.

3. The collective threats of climate change (i.e., economic, health, environmental, and political) could be addressed through a proactive solution.

4. Environmental benefits such as less pollution and waste could be realized through market-based solutions, with less reliance on heavy-handed government regulation such as vehicle emission standards.

5. Businesses and individuals would have a greater incentive to make new investments in technological innovations or energy efficiency, thus exerting a new measure of control over their own tax burdens.

6. The taxation of capital and business income could be greatly simplified or reduced without shifting the tax burden down the income scale.

7. New incentives would be created for investment in Research and development and the development of the businesses and technologies of the future, helping U.S. companies gain competitive advantage in new markets.

8. Inner cities could become more attractive business locations because of their abundant labor and available scrap materials.

9. Changes in energy prices could reduce congestion and make mass transit investment more viable for private investors, possibly reducing the need for public subsidies.

10. If there is a general consensus that taxing waste, and not work, is reasonable, public trust in government—and compliance with the tax system—will increase.

## A LOOK INSIDE
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