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Tax bads and untax goods with a green tax shift

By Fred E. Foldvary

The tax reform that would best promote liberty, the environment, and prosperity is to tax bad things instead of good things. Labor, entrepreneurship, and wanted products are good things, yet these get taxed as though they were crimes that need to be punished. **Pollution and congestion are bad things, yet these are in effect subsidized as though we wanted more of them.** The forced redistribution of wealth from the poor to the rich is usually considered a bad thing, yet government makes this transfer with taxes and subsidies.

Good products and activities are those that are voluntary, not just for the buyer and seller, but also for others who may be affected. Generally, production, trade, and consumption are good things, as they provide the goods that people want. Bad products and activities are those that are not voluntary, as they coercively harm others. **The prime examples of bads are pollution and congestion. Economists call these “negative externalities,” since they impose costs on others. For example, each extra car on a crowded road slows down the traffic for the other cars.**

A free market maximizes social well being. Any tax on voluntary enterprise reduces social well being, but also, any subsidy reduces social welfare. In a pure free market, all economic activity is voluntary, and those who impose costs on others are obligated to compensate the victims.

Taxes on wages, business profits, goods, and exchanges impose two types of costs on the parties. The first cost is the tax burden, the funds the taxed people have to pay to the government. This is a burden to the taxpayers, but it is not a cost to the economy, as the funds represent resources transferred from taxpayers to the recipients.

The second cost is called the “excess burden” or “deadweight loss” caused by the tax. Suppose you are buying a car for \$20,000 and there is a ten percent sales tax. The total cost is \$22,000 and if you borrow the funds to pay with, you need to borrow an extra \$2000, and pay interest on that extra amount. Those who would just barely be willing to buy the car at \$20,000 will not do so at the higher cost, so the purchase and production of cars gets reduced. Even those who do pay the higher cost get less net benefit, as the difference from the most they are willing to pay and what they actually pay gets reduced, reducing their benefits from the goods.

The excess burden is even worse than that for some products. For example, for goods such as books that have a global market, the seller can't raise the price, and the tax eats into the profit, and in many cases, that type of enterprise ceases to

function, and is replaced by one which can bear the tax but possibly creates less output and employs fewer workers. Any intervention in the market that drives out some enterprises will replace them with less-valued enterprises, since otherwise those replacements would have been there in the first place.

Taxes on wages, business profits, buildings, and trade all have such a deadweight loss. The total deadweight loss from taxation in the U.S.A. has been estimated to be over ten percent of total income. This is a sheer waste of resources, and the loss is much greater over time, as the economy could have grown faster if not for this drag on productivity.

Subsidies also have a deadweight loss, since the burden of the tax is greater than the benefits to those who are subsidized. That's because the subsidy gets some people to buy products at a lower price, but the extra benefit these people get from those goods is less than if they had bought the products they would have gotten if not for the subsidy. For example, suppose the government subsidizes pizza so consumers only pay a dime per slice. More folks would buy the cheap pizzas, but the value to them of the last extra slices is less than the cost of production, so this is really a waste of resources. With both punitive taxes and the handout of subsidies, resources are not allocated to where they are most wanted by those who would cover the costs.

The green tax shift would eliminate such excess burdens. It shifts public revenue to bad things and activities. When pollution crosses the owner's property and enters the property of others, including people's bodies, this is a trespass and a violation of others' property rights. When there are only a few people or firms involved, they can negotiate a settlement, or the victim should be able to sue for damages. But when there are thousands, even millions, of people involved, lawsuits become impractical. In that case, an on-going pollution charge can compensate society for the damages. If the government levies the charge, it can take the form of a tax, but in substance, it is restitution and compensation for damages. In form, the pollution charge is a tax on a bad activity, committing aggression against others by polluting.

Why not just prohibit the pollution? Because, the products have social benefits, which would be lost if the goods are not allowed to be produced. A pollution charge equal to the damages will reduce the output to the optimal amount, where the harm and benefit are balanced, along with compensating society for that pollution emitted.

Regulations are less effective than pollution charges, because regulations do not let firms and individuals adjust their activities according to their own costs and benefits. With pollution levies, firms and individuals have the choice of reducing pollution or paying the charge, and they will do whichever of these is less costly.

Pollution permits that can be bought and sold are more effective than regulations, but the gain from a higher permit price goes to the permit holder. The advantage of pollution taxes is that the revenue from these charges can be used to replace punitive taxes, those with deadweight losses. If pollution taxes raise \$500 billion in government revenue, and are used to, say, reduce income taxes, and they replace regulations, there is a double dividend: a cleaner environment, and greater productivity.

The same can be done with **congestion**. Tolls on crowded highways and streets, just high enough to let the traffic flow, put a charge on a bad activity, congestion, which eliminates it. Such tolls can now be implemented with electronic devices that automatically record the charge without the car having to stop.

Congestion tolls would replace taxes such as on gasoline. Gasoline is good - it makes our cars go. Transportation is a good thing, and as such should not be taxed. What is bad is the outputs - pollution and congestion, not the input, gasoline. Those who drive clean cars on uncongested roads do no harm and should not be taxed. Moreover, the efficiency of gasoline use should be nobody's business except the buyer. Why is it my problem if you waste resources you paid for? It's your problem.

Cash subsidies to special interests such as farmers are obvious, but other subsidies are just as real and costly to society. Quotas that restrict imports raise the price of goods such as sugar, and are in effect a tax on consumers. The greatest subsidy of all is the implicit transfer of wealth from workers to landowners.

When government provides public works and civic services - such as streets, transit, parks, security, fire protection, and schools - these increase the productivity and benefits of the locations served, and increase the demand to be located there. That generates higher rents and real estate values. If, as is usually the case, most of the funds come from taxes on wages, in effect worker tenants get double billed. A worker-tenant pays a higher rent because of the territorial services, and then he has to pay taxes to finance them. The landowners get subsidized by getting rent and land value paid for by the taxes on wages, goods, and business profits. Since landowners tend to be wealthier than renters, taxing wages to pay for civic goods amounts to a forced redistribution of wealth from the poor to the rich.

Subsidies are bads, so a tax on land value or land rent is a tax on a bad. In substance, it is a payment for services that generate rent and land value. Unlike taxes on production, a tax on land value has no deadweight loss, since the land will not flee, shrink, or hide when taxed. If a landlord was already charging the market rent, a higher tax on land will not be passed onto the tenant, since that would create vacancies.

The supply of land area is fixed, and land has no cost of production, so the rent is a pure surplus that can be tapped for public revenue with no ill effect. It can even have a beneficial effect if lazy landowners were not putting their land to its most productive use, since the land-value tax is based on the highest and best use of the

land as determined by the market prices of the neighborhood. After the tax is in place, a new land owner would have no tax burden, since the price of land would fall, and what the owner pays in the land tax, he saves in not having to pay mortgage interest.

Of course the same effect can take place if public works and civic services are privatized, as they are with condominiums, homeowner associations, and proprietary communities such as apartments and shopping centers. Members of condominiums pay a monthly assessment based on their membership and property rather than on their income or purchase of goods.

A complete green-tax shift would abolish taxes on wages, interest, dividends, transactions, and buildings, and replace these with charges for pollution, tolls on congested roads and streets, and the public collection of land rent. The pollution levy would also replace regulations and pollution permits. The economy would prosper from the elimination of the deadweight losses from both taxation and regulation.

Advocates of free markets should enthusiastically support the green tax shift, as this enhances liberty along with greater prosperity. There would be no more intrusive tax audits and no snooping into private financial affairs. There would be no tax evasion, since land cannot hide, and pollution levies are based on measured pollution. The penalty for refusal to pay the levy would be a loss of property, not prison. Entrepreneurship would be completely unshackled, and market prices and profits would no longer be distorted by taxes and subsidies, since levies on pollution and land value make users pay for the costs of their production and consumption.

Even if human activity is not contributing to global warming, the green tax shift is good for liberty and the economy. If pollution is causing climate change, then the reduction of harmful global warming would be a bonus.

Freedom is green, and the best environmental policy is a pure free market, since an inefficient use of resources needlessly destroys the environment. The promotion of a green tax shift would put the free market movement at the vanguard of the environmental and move it away from its current propensity to favor market-hampering regulation. **With the green tax shift, environmentalists and free-marketeers will find common ground.**

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