TAX REFORM IS GREEN
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EXECUTIVE SUMMARY

"Tax Reform" has become an empty catch-phrase used to describe virtually every tax-policy proposal. The reform moniker is used to support everything from eliminating tax preferences and lowering rates to greater wealth redistribution. Many so-called "reform" proposals seek to tap new revenue sources. Examples include tobacco taxes, internet taxes, and (most prominently in the environmental field) taxes on energy use and environmental emissions.

The call for "green" taxes is an unfortunate turn of events for both tax and environmental policy. Green tax proposals confuse means with ends and blur the objectives of both "true" tax reformers and sincere environmentalists. The imposition of special tax penalties or incentives designed to reduce pollution is not an efficient environmental strategy. Even if efficient environmental taxes could be designed in theory, they would create huge inefficiencies and be highly prone to political manipulation.

The failings of green tax-reform proposals obscure a larger truth: True tax reform itself, defined in terms of flattening rates and eliminating special tax favors, is a much sounder environmental policy than the highly-touted "tax reforms" environmental activists promote. Real tax reform, whether it takes the form of a flat-rate income tax, a simplified sales tax, or a cash-flow tax that rewards investment over consumption, would have a profound ecological impact. Real tax reform would:

- eliminate economic friction and waste caused by government interference in market decisions, resulting in greater efficiency and less pollution;
- accelerate the turnover of capital stock by reducing the tax burden on new investment and savings, thereby bringing new energy-saving and less-polluting technologies to market much faster;
- boost economic growth overall, helping businesses and individuals generate new wealth, which is the *sine qua non* of dealing effectively with environmental problems either in the public or the private sector.

So-called green tax reforms promoted by much of the environmental movement assume that government micromanagement of economic decisions is the only way to go; that public officials can accurately predict what kinds of private-sector actions and investments will pollute less, or pollute more; and that financial incentives (and penalties) built into tax policy will have a predictable effect on the environment, and no unanticipated side-effects. Common sense, not to mention the environmental degradation witnessed in nations with planned economies, tells us otherwise.

The greenest tax reform is that which does the most to reduce economic waste, encourage innovation and efficiency, and spur economic growth. From this standpoint, it is clear that the only green tax reform is one which lowers and flattens tax rates on economic activity.

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The old adage, "Be careful what you ask for, because you may get it," applies with particular poignancy to much of the environmental establishment's agenda. This is especially true when it comes to tax policy. Many environmental-activist organizations contend that higher taxes, fees, and selected "reforms" of the tax code, such as ending tax benefits for corporations in disfavored industries, will reduce pollution and protect the environment. "Tax pollution, not people," proclaims Friends of the Earth in calling for "environmental tax reform that would make pollution and depletion of natural resources more expensive while providing incentives for environmental protection."[1] Explains Worldwatch Institute analyst David Malin Roodman, "When it comes to environmental harm, it is better to tax than not to tax."[2] In sum, activists argue that "green" tax reform will put the American (and indeed the world) economy on a cleaner and more virtuous growth path. Utopia on a budget, as it were.

It is possible to advance economic growth and environmental protection simultaneously, but not by embracing the high-tax, slow-growth policies of so-called green tax reformers. True fundamental tax reform, with lower rates of taxation and less tax-driven political interference in economic decisions, actually can, in President Bill Clinton's words, "grow the economy faster while healing the environment," by spurring the technological innovation and wealth creation necessary for environmental protection. Efforts to manipulate market forces by tinkering with the tax code can never make that claim, and, unfortunately, President Clinton's remark is premised on the notion that state subsidies for "energy conservation, and the use of alternative forms of energy" are the way to go. The president thinks such manipulations prove that "it is no longer necessary to burn up the atmosphere to create economic opportunity," not exactly a ringing endorsement of the power of the market to make the world a better place. In fact, however, most green tax reforms rely on just this kind of state manipulation, and would leave us less wealthy and less clean to boot.

GREEN TAX REFORM = HIGHER TAXES

Proposals for green tax reform range from closing "loopholes" that allegedly subsidize the energy and mining industries[3] to new taxes on "pollution generation," taxes on energy use *per se*, higher fees for various users of public (*i.e.* government-owned) lands, and new taxes designed to inhibit development.[4] Advocates of these proposals sometimes offer partial offsets for the costs of their proposals, such as special tax breaks for green technologies, "renewable" fuels, or "energy-saving" activities, or couple them with selective relief from income or payroll taxes to give their "reform" packages a more populist bent. Nonetheless, green tax reform, even when designed to be revenue-neutral, inevitably means a net increase in the tax burden on Americans. Indeed, if pollution taxes achieve their stated goal of reducing emissions, they will also reduce government revenue, limiting the ability of green tax reformers to deliver on their pledge of replacing current taxes with "environmental" ones. More likely, environmental taxes will simply take their place alongside existing levies in the tax code. All in all, any effort to implement environmental taxes is likely to result in a net tax increase.

Green tax reform inevitably means a net increase in the tax burden on Americans.

Depending on the magnitude of that increase, it could indeed slow economic growth, which in the green worldview is a good thing. Many environmental activists believe the formula: slower growth = less production = less pollution. For these activists, any tax increase is a good thing, because it slows down the rate of economic growth and the rapacious consumption of American workers.

The fact that green tax reforms are cloaked in detailed analyses of how new tax incentives (and disincentives) will modify people's behavior,[5] suggests that these reforms are as much a marketing device as a serious policy approach. Straight tax increases aimed at reducing overall consumption and altering patterns of industrial activity in fundamental ways are not politically palatable. Hence, green tax reformers emphasize shifting the tax burden away from labor and onto "excess" consumption or resource use (as though workers aren't consumers). This sounds revenue-neutral, and some of the advocates of such a tax shift may sincerely believe they can avoid a net tax increase this way.

It is hard to believe, though, that any of the green-tax proponents are deeply concerned that their ideas might bring about a net increase in the tax burden. Examples of fledgling environmental tax reforms cited by Greenpeace, for example, include Swedish taxes on energy and pollution (enacted in conjunction with income-tax rate cuts) and Danish taxes on energy, fuel, water, and waste products (ditto). In both cases, the net effect was to introduce entirely new revenue sources for the national government, while preserving all existing revenue sources intact. In Sweden, total government receipts went from 63 percent of GDP in 1990 (before the eco-reform) to 58 percent of GDP in 1995, and back up to 61 percent by 1997.[6] Comparable data on Swedish tax revenues alone show an increase from 49 percent of GDP in 1995 to over 53 percent of GDP in 1997.

It is difficult to isolate the effect of the 1991 environmental tax reforms on the Swedish tax burden over this period, partly because those reforms were revisited several times during the decade—some taxes reduced, some increased and added, special exemptions carved out, *etc*.—and partly because any new tax has a ripple effect throughout the economy. Nonetheless, the reforms were not revenue-neutral for very long, if at all. The Swedish "tax shift" in favor of penalizing pollution and energy use was accompanied by a significant increase in the overall tax burden.

Did Sweden's eco-taxes do anything to help the environment? Some environmentalists say yes, pointing to a 50 percent (or more) drop in sulfur emissions. Yet such isolated statistics do not demonstrate that the plan produced environmental benefits. Such micro-effects may well have been swamped by the overall negative environmental impact of slowing economic growth from 2.2 percent in the 1980s to 1.2 percent in the 1990s. Other things being equal, slower growth will reduce a nation's output of everything, including emissions from industrial activity, transportation, and so on. Moreover, advocates of green tax reform maintain that an ecological tax shift is a "win-win" policy that will create new jobs and spur growth, particularly in environmentally friendly industries. Sweden's experience of a higher tax burden and slower economic growth does not support such claims.[7]

Sweden's record in the 1990s highlights a fundamental conundrum for the green movement, however. Whatever ecological feats that nation accomplished, they were accompanied by very slow economic growth. Tax shifts of various kinds may indeed reward today's environmental fads (wind power, recycling, bio-mass, *etc*.) and punish pollution that no one likes (*e.g*. contaminated waste water). But new eco-taxes also are likely to retard economic growth, and they indisputably intrude the judgment of government officials into new areas of private economic decision-making. In short, even if eco-taxes don't immediately add to the overall tax burden, they certainly add to the power of central governments to engage in "economic fine-tuning," "demand management," and "industrial policy." Given the poor environmental record of economic planning, this increase in government intervention is hard to justify on environmental grounds.[8]

That environmental tax-reform proposals increase government intervention in the economy is indeed ironic, since one key green critique of the tax-policy status quo in the US is that too many special preferences go to special interests, *e.g*. the fossil-fuels and resource-extraction industries. So-called green tax reforms would, if anything, exacerbate that problem, by reinforcing the government's power to manipulate economic behavior with narrowly focused tax provisions. Only truly comprehensive tax reform, by leveling the playing field once and for all (*e.g*. eliminating all special depreciation schedules in favor of immediate capital write-offs), would go to the fundamental problem of special tax subsidies greens like to complain about.

In sum, by pushing new taxes and tax-shifting that retard certain types of consumption, environmental activists embrace the idea that only more government, and more detailed and intrusive manipulation of our economic lives by public authorities, can clean up the environment. Rhetoric aside, no one today seriously believes more government brings more growth and opportunity. As *The Economist* has noted, "As people get richer, they want a cleaner environment—and they acquire the means to pay for it."[9] A substantial body of economic literature bears this out.[10] Thus, Swedish-style eco-taxes don't pass the test of ecological or economic soundness. Authentic tax reforms, if truly green, must be able to demonstrate a positive impact on wealth-creation, capital investment, and technological innovation.

WHAT IS TAX REFORM, ANYWAY?

Economists, scholars, and politicians disagree on what constitutes true tax reform. This is true whether or not they buy into the green tax agenda. One school of thought holds that reform means simply taking away special tax privileges that the wealthy, businesses, and politically connected taxpayers win in the legislative process. Eliminating these privileges, whether they are called "corporate welfare" or "tax breaks for the rich," is deemed to be reform in and of itself. The key criterion for such reforms is "fairness"—treating all taxpayers alike. A second school of thought holds that reform means designing tax policies that interfere minimally with people's economic lives. Such reform emphasizes simple rules, restraint on the overall tax burden, and a focus on revenue-raising pure and simple, rather than on promoting special interests of the left or the right.

The first approach is the "traditional liberal" concept of tax reform, one with a long and honorable history. The concept rests on some controversial assumptions, however, including the notion that progressive tax rates (as are contained in the present income tax) are inherently fair in themselves, and the belief that a "pure" progressive tax system would be possible if politicians would restrain themselves. The second assumption is easily dismissed by anyone familiar with public choice theory (or with Madison's analysis of the "play of interests" inherent in our constitutional order), and the first has been in doubt for some time, especially since the 1980s.[11]

The 1980s witnessed the birth of what we now think of as the modern tax-reform movement. When the Reagan administration first slashed tax rates, then sought to raise revenues with a frontal assault on tax loopholes, the seeds of a new intellectual convergence were sown. Traditional liberal tax reformers who wanted to eliminate loopholes joined with supply-siders who wanted the lowest rates possible. This new tax-reform movement drew bipartisan interest—Bill Bradley and Dan Quayle; Ronald Reagan and Dick Gephardt—leading to the groundbreaking Treasury Department reform proposals of 1984 and the comprehensive base-broadening, rate-reducing Tax Reform Act of 1986.

The 1986 act unraveled quickly, however, with a series of legislated tax-rate increases and the creation of a multitude of new loopholes. Ironically, that failure seemed to breathe new life into the movement for fundamental tax reform, which sorted itself out into two basic camps: advocates of a flat-rate (or near-flat-rate) income tax, typified by proposals from presidential candidate Steve Forbes and House Majority Leader Dick Armey; and proponents of a low-rate or flat-rate consumption or national sales tax, as embodied in plans put forth by Rep. Billy Tauzin and House Ways and Means Committee Chairman Bill Archer. For purposes of this discussion of the environmental implications of tax reform, this dual vision of what reform means—a low-rate income tax or a low-rate consumption tax, each with a broad base—will be the primary focus.[12]

GREEN THROUGH GROWTH

While many virtues have been claimed for fundamental tax reform, ranging from improving governmental accountability to promoting equity among all taxpayers, one of the pivotal arguments for both a flat income tax or a consumption tax is that they will increase economic growth. If we accept that growth is truly green—and a wealth of empirical literature demonstrates that it is—then that is also an important argument for tax reform from an ecological point of view.[13] What then does tax reform have to do with growth? Two basic arguments have been advanced.

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A low-rate tax reform would increase economic growth (at least over the long term), it is contended, because lower marginal tax rates themselves spur economic activity. This in essence is the supply-side argument for lower tax rates at the margin. As Nobel Laureate in Economics Robert Mundell points out, high marginal rates of taxation discourage additional work, investment, and production at the margin (as the tax price of doing so rises), thereby suppressing economic growth and providing diminishing revenue returns for government at the same time. While the supply-side analysis still is contested, responsible analyses of the tax-rate cuts of the 1980s by Larry Lindsey, William Niskanen, and others give strong support to Mundell's insight.[14] There are compelling reasons to believe that a low-rate fundamental tax reform would enhance the growth of the US economy, assuming rate cuts are not offset with excessive tax increases elsewhere. If supply-side analysis is correct, this would be true whether or not the tax base is broadened.

A second argument for the growth effects of tax reform is more complicated and really amounts to a series of arguments for specific provisions of most major tax-reform plans. The common thread among these arguments is the elimination of a multitude of distortions of economic decision-making caused by complex provisions of the existing tax code, many of which put a particular burden on savings, investment, and capital formation. The theory is that eliminating these distortions, which artificially steer economic decisions away from considerations of efficiency and market advantage and toward social-policy objectives that (because they are politically determined) can be arbitrary and capricious, will improve overall economic efficiency and productivity, raising the growth path above what it would otherwise have been. Interestingly enough, this efficiency/productivity argument for tax reform has several points of convergence with the ideology of eco-tax proponents, who believe we can eliminate waste and pollution with targeted tax changes that discourage business and consumer practices deemed harmful to the environment. The critical difference is that environmental activists want government bureaucrats to decide what is harmful or inefficient, while free-market tax reformers want market forces to make that determination.

Most of the tax-reform literature deals with this second line of analysis, partly because the US already cut tax rates significantly in the 1980s and thus has a track record with this aspect of tax reform; and partly because the great failing of the tax-reform movement in that decade was letting the tax code's biases against capital escape unscathed.[15] The key innovation in most major tax-reform proposals these days is the coupling of dramatic rate reductions with a concerted effort to remove that bias against capital, while at the same time simplifying tax compliance and administration.

Reducing the tax burden on savings, investment, and capital formation is probably the greenest possible tax reform. Here's why: A tax system that makes it more costly for individuals and businesses to invest necessarily slows the pace of technological innovation and risk-taking in the marketplace. If a business spends $10,000 to upgrade its computer system, under present law it is allowed to recognize only a fraction of that amount (determined by depreciation schedules, and varying according to the type of equipment or asset) as a cost of doing business. Since the business is still out the full $10,000, it is effectively taxed on its investment expenditure *per se*. Similarly, when a corporation hands out dividends to shareholders, those dividends are taxed as income to those shareholders, even though the corporation as a taxable entity already has paid tax on the income it used to pay out dividends. Such "double taxation" of corporate earnings burdens not just the business and the shareholder, but the savers and investors whose independent decisions about how to deploy their resources generate the capital all businesses and entrepreneurs draw on to finance new products and technologies.

This "capital wedge" imposed by the tax code is a major obstacle to environmental progress. First, it slows the process of bringing new eco-friendly products and services to the marketplace; not just the obvious examples, like pollution-control equipment (much of which gets special subsidies elsewhere in the tax code), but more efficient appliances, generators, processing techniques, inventory controls, transportation and delivery systems, and much, much more. The stronger the incentive for

ISSUE	Flat Tax (Armey)	Sales Tax (Tauzin)	"Cash Flow" Tax
Treatment of Savings and Investment	Investment income taxed to business only (no double taxation, no tax on interest, dividends, capital gains)	No tax (tax is only on consumer purchases and business purchases not used in production)	All net new savings exempt from tax; business taxed only on net receipts (minus all purchases, including capital expenses)
Write-offs for New Plants & Equipment	Immediate expensing; all costs of business subtracted from tax base	Immediate expensing; purchases in production process exempt from tax	All investment written off using accrual method accounting
Tax Rates/Brackets	Single rate (17%); high zero bracket ("personal allowance") (joint return, $22,000)	Single rate (15%); individual rebate (comparable to an exemption) tied to poverty rate	No current proposal; 1995 Nunn-Domenici plan had 3 "progressive" rates up to 40%, and an 11% business rate
*Mechanisms for Limiting Economic Distortion**	Three-fifths vote to raise rate (legislative rule)	Two-thirds vote to raise rate (legislative rule)	None

* Note that the flat-tax and national-sales-tax plans contain provisions (a supermajority requirement) aimed at preventing the new lower-rate, broader-based system from unraveling in future legislative action, as the 1986 tax reforms did. This is designed to head off criticisms that economic distortions can easily re-emerge in the years after enactment. For this reason, many sales-tax proponents advocate also eliminating the constitutional underpinnings of the income tax (*e.g.* the 16th Amendment).

a company to turn over capital stock, the faster more energy-efficient and minimally polluting technologies and products will take hold in the market. The capital wedge is a disincentive to turn over stock, and is anti-environment almost by definition.

Second, the capital wedge has an impact similar to that of high marginal tax rates: It suppresses the overall economic-growth path by adding to the cost of marginal economic activity. Since innovation of all kinds (whether it be new technology or creating markets for new products and services) happens at the margin by definition, the capital wedge is anti-environment because it is anti-innovation. One might say that the capital wedge built into the tax code is anti-environment in both a microeconomic (effects on specific decisions of businesses and individuals) and a macroeconomic (impeding the economic advance of the nation) sense.

In theory, it is possible to deal with these negative effects of the tax system on a piecemeal or "targeted" basis. That, in fact, has been the standard approach to tax policy in the postwar era, eschewing broad-scale reforms in favor of more narrow, tightly focused changes that affect a particular industry, even a particular company, rather than economic activity as a whole. The tax policies of the 1980s stand out as a notable exception to this trend, but even the reforms of that decade were accompanied by myriads of targeted tax breaks (and tax penalties) that are the inevitable result of a dominating federal presence in the national economy coupled with a tax system all too prone to political manipulation.

If anything, we should be surprised that the movement for fundamental tax reform has survived as long as it has, since the dynamics of the political process point tax policy in the opposite direction (the ability to grant favors through the tax code is an attractive way both to lure campaign contributions and reward specific political constituencies important to the electoral process). Even in the 1990s, political leaders have rediscovered the virtues of rewarding savings and investment through the tax code, albeit with a very narrow-gauge approach (special breaks for college savings, conditional reductions in the capital-gains tax rate). From an environmental standpoint, however, these kinds of targeted adjustments accomplish little. To have a truly profound ecological impact, tax reform has to be bold, sweeping, and comprehensive.

GAINING THE EDGE

Wholesale tax reform has several key advantages from an ecological standpoint, and the most important of these are characteristic of all the major reform initiatives: the flat tax, the so-called cash-flow tax on income, and the national sales tax. The most familiar prototype for the flat tax is H.R. 1040, introduced in the 106th Congress by Rep. Dick Armey (R-TX) and based on the work of Hoover Institution economists Robert Hall and Alvin Rabushka; for the national sales tax, the prototype is H.R. 1467, introduced by Rep. Billy Tauzin (R-LA).[16] Either as conceptual proposals or in legislative form, each of these initiatives would end multiple taxation of savings and investment; remove tax burdens on investing in new equipment, plants, and technology; and remove the multiple distortions of economic activity caused by tax-code provisions aimed at promoting certain social, investment, or industrial policies. In addition, all have the compelling virtue of slashing and capping tax rates, thereby reducing the tax wedge that inhibits productive economic activity at the margin.[17]

Greening the Economy by Fundamental Tax Reform

Status Quo	*Fundamental Reform*
o Micromanaged Market Decisions	*o Minimum Intrusion in Market*
o Friction, Inefficiency (compliance, paperwork)	*o Minimal Friction (but not zero)*
o Slower Pace of Capital Turnover, Innovation	*o Faster Turnover of Capital Stock*
o Uncertainty/Short Term Focus	*o Relatively Stable Tax Environment*

The means to these ends are somewhat different in each case, of course. The flat tax would be imposed on both individuals and businesses, but all investment-type income (*e.g.* dividends) would be taxed to the business only. Note that this means individuals would not be taxed on capital gains received from their investments. All business investment would be written off ("expensed") in the year in which the outlays were made. The cash-flow tax, on the other hand, would not be imposed on businesses, but individuals would pay tax on income from all sources (including investments) while deducting all their savings and investment on a current basis. Business investment in new equipment, technology, *etc*., would effectively be expensed under this approach as well as under the flat tax, since taxable returns to investors would be determined by the business and reflect current-year write-off of such costs.

In sum, environmental activists embrace the idea that only more government can clean up the environment.

The national sales tax would achieve similar results, policy-wise, through rather different means. Since the tax is designed to be a wholesale substitute for the income tax, by definition there would be no taxes impinging on savings, investment, and capital formation *per se*. The Tauzin proposal (H.R. 1467) also specifically excludes all business purchases from taxation, including, of course, expenses of investing in new technology, equipment, and so on.

It is important to note also that each of these major prototypes for tax reform is intended to replace not just the income tax, but the estate and gift taxes as well (aside from the payroll tax, these taxes combined provide the bulk of federal revenues). Eliminating these taxes is important not just for conceptual reasons (since they supposedly function as a "backstop" to catch wealth that escapes taxation as current income), but from an ecological standpoint as well. The particular burden the estate tax imposes on land that has appreciated over time encourages early subdivision and development of rural and agricultural land that might otherwise be kept in productive use for farming or voluntarily preserved as habitat for wildlife.[18] As wildlife specialist Michael Bean of the Environmental Defense Fund observes, the estate tax is "highly regressive in the sense that it encourages the destruction of ecologically important land in private ownership."[19] "Some of the best remaining habitat for endangered species is put at risk" due to the estate tax, concluded a report of the Keystone Center.[20] Growth is green, but artificial incentives to divert land (or any asset) from its owners' preferred use is neither a recipe for economic efficiency nor a prudent approach to land management.

All three models of true fundamental tax reform—the flat tax, cash-flow tax, and sales tax—would advance sound ecological practices by encouraging (or rather, removing barriers to) faster turnover of capital stock, the generation of venture capital, and overall savings and investment by both individuals and businesses. This is good for environmental protection not just because it stimulates economic growth, but because it eliminates endless sources of tax-induced friction that literally waste economic resources and generate environmental harms. The paperwork, administrative requirements, specialized services (law, accounting, *etc*.), and manipulation of economic decisions dictated by the current tax code pollute the environment by diverting those resources from their highest and best use. Plants that pollute may be kept in operation much longer than they need be, because of the capital wedge that raises the cost of replacing or upgrading them. Installing more energy-efficient production-line equipment may be postponed for the same reason. Tax reform isn't just about saving trees buy cutting paperwork requirements; it has the potential to cut costs for every unit of production in the economy and move us more rapidly toward the clean, green, emerging high-tech economy that everyone sees as the wave of the future. As the following chart shows, technological advances resulting from new capital investment have resulted in important environmental gains.

Eco-Benefits of Technological Innovation: The Ecological Profits from New Plants & Equipment

1. GROCERY PACKAGING (lbs. per production unit)

1989 — 2,750 1994 — 2,100

2. TIMBER HARVESTING & PRODUCTION (% that is waste/residual)

1970 — 26% 1993 — Under 2%

3. PARTICULATE MATTER EMISSIONS (total emissions per capita)

1970 — 0.5% 1995 — 0.12%

Source: for points 1 and 2, Lynn Scarlett, "Doing More with Less: Dematerialization—Unsung Environmental Triumph?" chapter 3 in *Earth Report 2000* (McGraw-Hill, 1999); for point 3, Indur Goklany, "Clearing the Air: The Real Story of the War on Air Pollution," chapter 4 in *Emissions Trends and Technological Change* (Cato Institute, 1999). As Goklany notes, "Peaks in the leading environmental indicators help identify when 'cleanup' efforts began, either consciously or unconsciously, due to economic and technological progress....capital stock, which determines the fuel mix used by society, combustion efficiencies, the types of industrial and manufacturing processes used, age distribution, and emissions profiles of vehicles, and the efficiency of any pollution control equipment, cannot be turned over rapidly" (74). But it will turn over *more* rapidly under tax reforms that allow capital expensing.

Even if the economy of the future is somewhat different than the analysts predict (it almost always is), fundamental tax reform will get us there faster with less cost to the environment. Green is Good in today's marketplace, and businesses in every sector of the economy are looking for cost-effective ways to provide products and services while using less energy, putting fewer pollutants into the air and water, recycling materials where possible, and protecting habitats. Tax reform can help them get there faster, and make green marketing more than just a slick ad campaign.

THE PITFALLS AND THE PROMISE

There is danger, however, in taking it for granted that the ecological virtues of fundamental tax reform which we have highlighted will be true for any tax reform proposal that comes down the pike. The key ingredients tax reform must have to benefit the economy and the ecology are low rates (as low as possible); reducing if not eliminating taxes that burden or interfere with decisions on savings and investment; and immediate write-off of capital investment. With these three elements in place, tax reform can indeed make us cleaner, greener, and wealthier at the same time.

Just because a tax-reform proposal meets the above test, however, does not mean it will automatically retain those virtues through the legislative process, or remain intact over time. The great irony of the Tax Reform Act of 1986 is that, having established a point of (economic and political) equilibrium in the tax code, it began to unravel almost before the ink was dry. The much-vaunted compromise between marginal-rate reduction and "loophole closing" (now referred to as "corporate welfare," a term more aptly applied to appropriated government subsidies for business interests) proved to be highly unstable, whether because rates weren't lowered enough or because the act's choppy and disjointed approach to cutting back special tax privileges was an open invitation to rewriting the tax code on an annual basis. Both probably played a part; the point is that even the best tax reform needs some sort of backstop, either through statutory or constitutional restraints on the taxing power—the Armey flat tax and Tauzin national sales tax each incorporate a supermajority requirement for raising taxes—or by becoming the basis of such a strong political movement that it can withstand at least the most egregious attempts to return to special-interest tax policy. Neither development appears to be on the horizon, so environmentalists and tax reformers alike need to be vigilant, prudent, yet hopeful in dealing with specific legislative proposals and projecting their likely impacts.

If the environmental movement and the tax-reform movement could only find a point of convergence, the prospects for building a resilient political coalition in favor of fundamental tax reform would be dramatically improved. Indeed, there is such a point: Environmental activists want tax policy to restrain consumption (which they regard as inherently wasteful), while most tax reformers agree that shifting tax policy toward a consumption base is a *sine qua non* of meaningful reform. All three of the tax-reform prototypes examined do that, by effectively taking income that is saved and invested out of the tax equation, leaving only income that is spent or "consumed" subject to tax. Admittedly, that is a different concept of taxing consumption than most eco-tax proposals envision, since hard-core greens want specific taxes on specific products or services that they (in practice, government bureaucrats) decide are particularly egregious in generating pollution or threatening long-term ecological harm. Carbon taxes to discourage fossil-fuel use and (allegedly) head off global warming; pollution taxes on industrial output; tax penalties on nonrecycled products; that's the sort of thing they have in mind.

Tax reform isn't just about saving trees buy cutting paperwork requirements; it has the potential to cut costs for every unit of production in the economy.

If environmental activists can disabuse themselves of the notion that omniscient public officials can micromanage the ecological impact of economic growth through tax policy, and tax reformers can give them reasons to trust the market more than the government, some interesting things could happen. Both camps dislike special government privileges for large and entrenched interests (business or otherwise), and both recognize that we could do a much better job of promoting economic growth along with ecological sensitivity.

Ultimately, policy choices about taxation as it relates to environmental policy come down to value judgments: Which do you trust more to advance the public interest, the hidden hand of the market, or the manipulations of state power? It is clearly untenable to maintain that governmental interference in economic decisions, through tax policy, is cost-free, more efficient, or likely to lead to sound (or even acceptable) tax policy over the long run. The opportunities for political mischief with the tax code are just too great. Such an approach will not advance environmental protection, either.

At the end of the day, the greenest tax reform is that which does the most to reduce economic waste, encourage innovation and efficiency, and spur economic growth. From this standpoint, environmental tax reform should be fundamental tax reform.

NOTES

[1] Friends of the Earth, “Environmental Tax Reform,” available at www.foe.org/envirotax/.
[2] David Malin Roodman, *The Natural Wealth of Nations: Harnessing the Market for the Environment* (New York: W.W. Norton, 1998), p. 149.
[3] See, for example, Friends of the Earth, *Dirty Little Secrets*, a survey of such tax advantages published in 1995.
[4] For a good summary of some of these concepts see an article by Brian Dunkiel, M. Jef Hammond, and Jim Motavalli, “Sharing the Wealth,” *E Magazine* (March-April 1999).
[5] “Tax policy…merely creates incentives or disincentives, and it’s a tool to complement environmental laws. Tax-based policies shift green reforms from ‘end of pipe’ penalty solutions to economic incentives, a move that businesses should support because it reduces their regulatory burden.” Dunkiel, *et al.*, p. 5.
[6] These numbers are based on Organisation for Economic Co-operation and Development statistics on government receipts, which include all sources of income to the government, not just taxes. *Revenue Statistics of OECD Member Countries*, 1998 edition.
[7] Of course, a complete understanding of the marginal impact of Sweden’s reforms would require a massive review of Sweden’s economy in the 1990s to sort out the relative contribution of each and every factor, ranging from the country’s accession to the European Union to regional and global economic trends.
[8] See generally, Mikhail S. Bernstam, *The Wealth of Nations and the Environment* (London: Institute for Economic Affairs, 1991).
[9] “Why Greens Should Love Trade,” *The Economist*, October 12, 1999.
[10] See, for example, Seth W. Norton, “Property Rights, the Environment and Economic Well-Being,” in *Who Owns the Environment?* Peter J. Hill & Roger E. Meiners, eds. (Lanham, Maryland: Rowman and Littlefield, 1998), noting that “consumption” of environmental quality increases as wealth increases. See also Indur Goklany, “Richer Is Cleaner,” in *The True State of the Planet*, Ronald Bailey, ed. (New York: The Free Press, 1995).
[11] See Walter Blum and Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation* (Chicago: University of Chicago Press, 1953). This pivotal analysis of progressivity in taxation reluctantly endorsed retaining progressive tax rates; a fresh look in 1982 by co-author Blum raised more serious concerns about progressivity. See Blum, “Revisiting the Uneasy Case for Progressive Taxation,” in *Taxes—The Tax Magazine* (January 1982).
[12] Note also that this analysis is limited to alternatives to the US income tax. The payroll or Social Security tax, while equally significant as a source of federal revenue, already functions as a single-rate tax and, while it has a huge economic impact, is much more neutral among different economic players and lacks the history of constant manipulation which characterizes the income tax. However, some comprehensive income-tax-reform proposals do attempt to integrate the payroll tax into their systems as well.
[13] This view is not universally accepted, the counter-argument usually being that higher levels of production bring more pollutants. But they also bring more wealth to deal with those pollutants, new technologies to reduce pollution, and usually higher levels of education that both increase awareness of environmental issues and generate the intellectual capital new generations need to make advances toward a “clean and green” future. See, for example, discussion of these issues in Julian Simon, *The Ultimate Resource 2* (Princeton: Princeton University Press, 1996).
[14] Larry Lindsey, *The Growth Experiment* (New York: Basic Books, 1990); William Niskanen, *Reaganomics* (Oxford: Oxford University Press, 1988).
[15] The Tax Reform Act of 1986 made some token efforts in this direction (*e.g.* limited interest deductions), but in such a piecemeal, haphazard, and inconsistent way that many analysts contend it actually increased the burden on savings and investment.
[16] At present, there is no legislative proposal that embodies the cash-flow tax idea, although the Treasury Department prepared a conceptual proposal (not legislation) along those lines in 1977.
[17] For an excellent and concise taxonomy of the major approaches to fundamental tax reform, see Steven Entin, “Growth-Friendly Tax System,” a paper prepared for the National Commission on Economic Growth and Tax Reform (“Kemp Commission”) in 1996 and available at www.townhall.com/taxcom/.
[18] See, for example, Jonathan H. Adler, “Repeal the Death Tax for Mother Earth,” *Investor’s Business Daily*, April 22, 1999, and “The Anti-Environment Estate Tax: Why the ‘Death Tax’ Is Deadly for Endangered Species,” CEI *On Point*, April 20, 1999.
[19] Michael J. Bean, “Shelter from the Storm,” *The New Democrat* (April 1997).
[20] The Keystone Center, *The Keystone Dialogue on Incentives for Private Landowners to Protect Endangered Species—Final Report* (Washington, DC: Keystone Center, 1995), p. 26.

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