

## **Ecological Tax Reform in Minnesota: Answering the Critics**

**T**he concept of an ecological tax reform is new, but already a conversation is blossoming in many parts of the country and world. A recent conference held in Minnesota focused on ecological tax reform at the state level. The participants raised several key questions regarding the concept. In his closing remarks, David Morris of the Institute for Local Self-Reliance addressed those questions. His responses are summarized below.

### **Q. Why would Americans support ecological tax reform?**

**A.** Pollution taxes make sense. They are easy to explain and justify.

People quickly grasp that the current tax system is inefficient because it taxes beneficial activities that we would like to encourage while not taxing, or taxing at a very low rates, harmful activities we would like to discourage. This distorts prices and in the long term, distorts behavior. Taxes on property drive up the cost of housing. Taxes on labor raise the cost of workers. Taxes on investment raise the cost of capital. Meanwhile low or nonexistent taxes on energy or pollution encourage wastefulness.

One way to respond to these tax distortions is to sharply raise taxes on pollution and natural resource extraction and sharply reduce existing taxes on property or labor or investment. In brief, tax pollution, not people or property.

Most existing taxes can be justified only because government needs the revenue. Pollution taxes are inherently justifiable because pollution has a cost. In Minnesota the state energy agency estimates that pollution costs Minnesotans at least \$1 billion a year. One could argue that even if government didn't need the money, we should impose pollution levies or taxes simply to make the goods and services we buy reflect their real cost.

Pollution taxes boast another unique and attractive feature. They are the only tax where tax avoidance is legal and encouraged. Taxpayers are urged to improve the efficiency with which they use energy or to switch to renewable resources. Both actions would reduce their tax payments while at the same time enriching the overall economy.

### **Q. Why is now the time for ecological tax reform?**

**A.** The issue of tax restructuring is already on the political agenda in Washington and in many states.

Most tax reform proposals involve extending state sales taxes or imposing a national value added tax. Both of these are consumption taxes. Pollution taxes are a form of consumption tax too. But unlike broad sales taxes pollution taxes target only those activities that are socially harmful. They can and should play a role in any tax restructuring effort that involves consumption taxes.

A number of states, including Minnesota, are seeking alternatives to local property taxes as a way to finance the public school system. In 1995 the Minnesota House of

Representatives approved a state constitutional amendment that would require the state to finance public education. A pollution tax of \$1 billion in Minnesota, the actual cost of pollution according to the state energy agency, could replace about half the local property tax share of the education budget.

**Q. What would be the effects of ecological tax reform on the overall economy?**

**A.** No economic analysis at the state level has yet occurred. But several are underway in Minnesota and New York. On the national level, a number of econometric analysis have concluded that the nation can benefit from imposing stiff pollution or energy taxes if the revenue generated is used to reduce taxes on income and investment. Similar modeling exercises in several European nations have shown that ecological tax reform can result in increases in national income and employment.

**Q. How will pollution taxes affect poor people? Isn't this a regressive tax?**

**A.** Yes, a pollution tax will disproportionately effect lower income households. However, one must remember that ecological tax reform is revenue neutral. It does not represent an overall increase in taxes but a shifting in the way we tax. A tax restructuring can be designed to return revenue to households or workers or low income groups. For example, the revenue generated by the pollution taxes could be used to expand the earned income tax credit, thereby raising wages and reducing poverty. For the non-working poor, household energy efficiency programs could be dramatically expanded.

**Q. Won't pollution taxes make Minnesota's industries less competitive?**

**A.** The fastest growing industries in most states both in terms of jobs and sales are the service and knowledge intensive industries.

Minnesota's largest industry is health services and medical technology. Energy intensive and mineral extraction industries will play a diminishing role in the nation's and the state's future.

As was pointed out before, ecological tax reform has two elements. One involves a tax increase and the other a tax decrease. For industries that are labor intensive and not energy intensive, a pollution tax coupled with a reduction in labor costs by having the state pay, for example, the employer's contribution to social security or a reduction in the commercial property tax, would probably generate a net benefit.

Even for heavy industries, the impact of a pollution tax varies. One study found that a \$50 tax per ton of carbon emitted would impose a cost equal to more than 2 percent of sales on only a handful of the more energy intensive industries.

In Europe, energy intensive industries engaged in export are often exempted from carbon or energy taxes. In Denmark this exemption is conditional. For firms engaged in export, refunds of the tax are possible depending on the ratio of the tax relative to the value added in production. In cases where firms qualify, refunds are permitted only if "reasonable" energy efficiency investments are undertaken.

**Q. Won't some people and companies be hurt?**

**A.** Yes. However, an ecological tax reform can and should be designed in order to maximize the benefits and minimize the harm to any given sector. One general principle

accepted by most advocates is that each sector (commercial, industrial, household, agriculture) should receive tax reductions or payments equal to the amount of pollution taxes it pays. Thus industry could receive reduced property taxes while households receive reduced residential property taxes.

However, although the sectors are “held harmless”, individual firms and households within those sectors would be hurt or helped depending on their efficiency. For example, mini mills that rely on scrap steel would benefit compared to the more energy intensive blast furnaces that rely on virgin iron ore. Farmers who use conventional cultivation practices would pay more taxes than farmers who use no till or low tillage farming practices. The overall tendency of ecological tax reform is to encourage and reward more efficient consumption habits.

**Q. Won't government revenues become unpredictable or decline with pollution taxes?**

**A.** First of all, pollution taxes should not be set at such a high level that government would become dependent on them. A billion dollar pollution tax in Minnesota would displace about 5 percent of combined state and local tax revenue.

Pollution taxes should have the same short term predictability as other forms of taxes. That is, the revenue stream can be projected with as much adequacy as revenue from income or sales taxes.

In the longer term, one could expect that pollution taxes will lead to reduced pollution and less government revenue. There are no state based models that can provide a foundation for making an estimate of revenue loss. Nevertheless, a 10 percent reduction in revenue over a ten year period might be a reasonably educated guess from a high pollution tax. However, if pollution taxes are shifting behavior to this extent, they should also be shifting economic activity in the direction of the increased production of beneficial activities. This translates into an expanding economy. That increased activity in the form of expanded payrolls and increased income should result in higher tax revenues for government.

Finally, as polluting behavior declines, government can reduce budgets that now are used to protect the environment and clean up existing pollution. It may also be possible to reduce the complex web of environmental regulations that impose not only a public but a private cost as well.

**Q. Why should Minnesota go it alone? Shouldn't it wait until the Congress enacts a national pollution tax?**

**A.** Several small European nations with economies and populations about the size of Minnesota have decided not to wait for a European wide ecological tax reform but rather to unilaterally impose their own tax restructuring. This is true even though the internal free trade zone of Europe makes the economic relationship between Denmark and France similar to that between Minnesota and Indiana.

Countries like Switzerland and Denmark and Sweden are introducing carbon or energy taxes as part of an overall tax restructuring. They are doing so because they believe the benefits outweigh the risks. They believe they can fashion a tax that protects their existing export oriented businesses while reducing pollution and increasing employment. In Switzerland the CEOs of leading industries have taken the initiative and proposed their own ecological tax reform.