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## Pigou You, Too

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Will the government get addicted to carbon taxes?

 [090227\\_TBM\\_smokestack.jpg](#) [1]

One of the centerpieces of the budget proposal that the Obama administration unveiled yesterday is an ambitious environment plan to reduce greenhouse-gas emissions. The plan—which would require the owners of big sources of carbon, such as power plants, to pay the government for each ton of CO<sub>2</sub> and other greenhouse gases they release into the air—is something that environmentalists have wanted for a long time. It's also something a lot of economists have wanted for a while, and thus a big success for a school that has its roots in the thinking of British economist Arthur Pigou and is very much in vogue now.

A tax on carbon emissions is a form of what economists call a "Pigovian tax." (For some reason in the transition from the man to the theory, the "u" in *Pigou* generally gets dropped.) Such a tax imposes a cost on behaviors that have negative effects on the people around you. It accomplishes the double purpose of discouraging undesirable behavior and raising revenue to compensate for negative spillover effects. A Pigovian tax might require owners of humongous speakers to pay up when they turn up the volume or (maybe more realistically) when they buy the speakers. Cigarettes, which boost health care costs, are now taxed to subsidize those costs.

Harvard economist Gregory Mankiw, the chairman of the Council of Economic Advisers for part of George the 43<sup>rd</sup>'s term, is a particular proponent who has long advocated carbon taxes—as an environmental solution. Mankiw maintains an informal list of like-minded economists and pundits called [the Pigou Club](#) [2]. By Mankiw's count, the Pigou Club includes most of the big-name economists and economic journalists in the country, which makes sense: Who doesn't like the idea of billing social troublemakers like big polluting coal plants for the costs they impose on everyone else?

With the new economic proposal, the President Obama takes a central seat in the Pigou Club. The administration's plan isn't *exactly* a Pigovian tax, but it's very, very close. The long-range budget plan that the president unveiled envisions the government collecting \$646 billion in revenue from 2012 to 2019 by charging companies—mainly the owners of oil refineries and power plants—for permits to release carbon and other greenhouse gases. The more carbon an industry emits, the more it would have to pay, creating incentives for energy producers (the big carbon emitters) to move away from cheap but greenhouse-gas-spewing sources like coal to natural gas, wind, and other options.

The difference between this and the classic Pigovian tax idea is that the Obama plan adds a hard cap to emissions, a feature of carbon reduction schemes known as "cap-and-trade." That solves one problem of tax plans—they leave you unsure of just how much they'll reduce emissions. But it also avoids some of the risks of gamesmanship of cap-and-trade plans—already in place in the European Union—which let companies trade carbon credits and can end up benefiting the operators of big coal-fired plants, which reap big rewards for cutting their output. You can see an interesting, though technical, discussion of carbon-cutting approaches from Peter Orszag, now Obama's budget director, [here](#) [3]; the Obama plan does combine some of the benefits both of taxes and of cap-and-trade.

From a budget perspective, though, the Obama plan has an advantage that has nothing to do with its environmental benefits: It raises money. A lot of money. Of the \$80 billion a year or so that the president's plan would raise from auctions of emissions credits, about \$15 billion would go toward other energy-efficiency and global-warming-reduction programs. But the bulk of it would not. According to the budget proposal, the other \$65 billion would go to a federal tax credit of \$500 for individuals and \$1,000 for families.

The idea of linking carbon taxes to a tax credit that would offset some payroll taxes (the taxes that lower-earning workers justifiably hate, because they start at the first dollar of income) owes a lot to [a very similar plan put forth by economist Gilbert Metcalf](#) [4]. Tying greenhouse-gas costs to a tax credit lets supporters of the environmental plan say that it doesn't come out to very much of a net tax increase and effectively pays folks back for the higher energy costs it will create. But to say that selling emissions permits "pays for" the tax credit is really no more or less true than to say that it "pays for" much of the \$634 billion the budget would put into expanded health care access. The bottom line is still that by taxing carbon emissions, the government makes close to \$65 billion a year.

In the long run, that may turn out to be the dissonant note in the Pigovian tax party. Pigovian taxes are potentially a very big source of income for the government. And how you set them in the near term is influenced at least as much by the prospect of maximizing revenue as that of ameliorating the problem they were designed to solve in the first place. In some cases, the economic costs of the tax can wind up eventually outweighing the social costs of the behavior. A lot of New Yorkers think that's the case with New York parking tickets; in some neighborhoods with insufficient space, they are almost impossible to avoid and so have less to do with making street cleaning easier than with raising government funds. In other cases, the need to preserve revenue eventually outweighs the goal of changing the behavior.

Once \$65 billion a year is coming from the sale of carbon credits, whether you want to say they're paying for health care, a tax credit, or something else, it's hard to go back. One of the questions with any Pigovian tax is what level you set it at. Do you set it at a level that most perfectly balances out the social harm? Do you set it at the level that most effectively discourages the behavior you don't want? Or do you set it at the level that maximizes the money you take in? This becomes a very difficult choice to make when there is a big chunk of the federal budget in the balance. The risk of Pigovian taxes is that the tail of the tax can end up wagging the dog of environmental policy. Just take a look at most state budgets and find the line for revenue from cigarette taxes. Bad behaviors, whether cigarettes or fossil fuels, are addictive; so, too, for government is the money that comes from taxing them.

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