



# Free-Market Environmentalism

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Many of you may be unaware, but this past week was [National Clean Energy Week](#). And, while many economically harmful policies have been proposed in pursuit of clean, efficient, and cost-effective renewable energy, the goal is worthwhile. It just matters how we get there.

The [Clean Capitalist Coalition](#) (full disclosure, I participate in this coalition) is proposing an innovative approach that can help encourage clean energy innovation without harming economic growth.

The traditional approach recommends penalizing unwanted behavior. Curbing greenhouse gas (GHG) emissions, for example, is best achieved (according to this approach) by imposing a tax on emissions. This tax raises the price of GHG emitting activities (e.g. heating your home in winter) and, as basic economics teaches, raising the price of an activity decreases its consumption. The problem is this impact was achieved by imposing a negative incentive.

When the government imposes a negative incentive, several unwanted consequences necessarily follow. First, a carbon tax, like all taxes, imposes costs on the economy. These costs include higher home energy costs that harm low-income families the most, higher production costs, less economic growth, and diminished living standards.

Second, when a negative incentive is imposed, all that is known with certainty is what people won't do - they won't engage in as much of the taxed activity. What people will do is unknown. In the case of the emissions tax, perhaps factories will relocate to other jurisdictions where the tax is not imposed, and energy costs are, consequently, cheaper. California exemplifies how higher costs caused by green energy policies can contribute

to an [exodus of businesses](#). These business relocations accentuate the economic losses associated with an emissions tax and can even work against the goal of reducing global GHG emissions if production moves to less efficient jurisdictions.

These unintended consequences do not occur if the emissions reduction strategy embraces positive, instead of negative, incentives. Positive incentives focus on promoting innovation instead of punishing the activities that create the externality. In practice, low-emission innovations can be incentivized by providing broad-based, technologically neutral, marginal-tax rate reductions for technologies that reduce greenhouse emissions – what the coalition calls clean tax cuts.

CAFE standards exemplify the possibility.

[Mandatory CAFE standards](#) impose large economic costs, which is why EPA's recommended freezing of the rising standards is the right policy. While a mandatory decree from Washington D.C. is not the answer, incenting better fuel efficiency is still possible.

As Ian Adams from the R Street Institute [noted](#), imagine if the current CAFE standards were repealed and replaced with a voluntary clean tax cut. A possible application of this policy could impose the current corporate income tax rate of 21.0 percent on the profits of all automobile manufacturers whose average fuel economy fall below a certain threshold – say 35 mpg. Marginal tax rate reductions would then be available for all manufacturers whose average fuel economy standards exceed that benchmark.

Furthermore, greater fuel economy can be incentivized by offering continued tax rate reductions for even greater fuel economy achievements. To get a sense of the significant improvement in incentives, imagine if manufacturers who meet President Obama's 54.5 mpg standard were granted tax-free income. This would increase manufacturer's after-tax profitability, on a static basis, by 26.6%! Offering a discounted tax rate of 10 percent would increase manufacturer's after-tax profitability by a still hefty 13.9 percent.

Such a large increase in manufacturer's profitability would provide a powerful incentive for automobile manufacturers to increase their fuel economy standards without any mandates. Just as importantly, those innovations would have to provide value to consumers as well – otherwise, they wouldn't buy these vehicles.

The clean tax cut approach does not impose penalties on producers and consumers, therefore there will be no economic costs from the policy. There will be lower government revenues of course, but these lower revenues only occur if the average fuel economy of cars increase.

Further, there are many potential spending offsets that can “pay-for” any lost revenues. Perhaps most fittingly, federal expenditures that harm the environment, such as ethanol subsidies, can be targeted. Such “green scissors spending cuts” can ensure that the tax reductions do not increase the deficit while creating additional environmental benefits.

The current penalty-heavy, government-centric, approach to reducing greenhouse gas emissions imposes heavy costs on the economy. By focusing on the problem rather than the solution, many unintended consequences arise. Clean tax cuts empower the free market to address this problem. By utilizing positive, rather than negative, incentives clean tax cuts provide a pro-growth policy that promote economic prosperity and a cleaner environment.

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