# make prices tell the truth: shifting taxes from goods to bads

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Taxes are the DNA of our economy: invisible, cryptic, and awesomely powerful. Like genetic codes, tax codes send out signals that influence billions of actions daily.

Economists see taxes as disincentives because the most elemental signal sent by a tax is that a purchase, service, or behavior is going to cost extra money. When something is taxed, we usually get less of it. So what do we tax? Mostly we tax paychecks, profits, commerce, and buildings—all of them "goods" that we want more of as a society. We do not tax, or tax far less heavily, things like pollution, waste, and sprawl—"bads" that we want less of as a society.

In Oregon, for example, the combined tax rate on each dollar of take-home pay for a middle-income family is 31 percent, while the tax rate on each dollar spent on pesticides is 0 percent. As a result of this upside-down tax code, we end up with fewer goods and more bads; we're both poorer and more polluted.

Fortunately, an innovation called *tax shifting* can turn the revenue system right side up. It moves taxes, dollar for dollar, from goods to bads. Along the way, it corrects one of the most glaring flaws of market economies—our blindness to costs that are not included in prices because someone else is paying for them. These costs can include the cost of building better roads for a new shopping mall, the cost of cleaning water in bays, rivers, and streams, or even the cost of a military presence in the Middle East. Economists call costs that are not included in the prices of goods and services *negative externalities.* These costs also include reduced health and well-being paid for by the public, in such forms as shortened lives, increased cost of healthcare, and a degraded environment.

Tax shifting harnesses the profit motive for what economists call *efficiency* as well as for social and environmental ends because it forces the market to account for negative externalities by adding them to the cost of a service or product.

Costs are rightfully shifted to those who benefit from producing or using the service or product. The taxes collected can be used to carry out the public's business. Taxing bads and using the money to reduce income and employment taxes would grow the economy and give the market incentives to reduce things we do not want, such as pollution. Well over a dozen European nations have enacted tax shifts of various forms, and Japan, which is considering carbon taxes, is following their lead.

## Tax Pollution

What does tax shifting look like in action? Consider the example of pollution taxes. Each year, northwesterners send more than a million tons of harmful substances into the region's air, land, and water. This pollution causes hundreds of premature deaths yearly in the region and contributes to other ailments. In addition, the region's vehicles and other combustion devices unlock from fossil fuels about 200 million tons of climate-changing greenhouse gases per year.

Pollution taxes would impose a fee on each ton of pollution emitted, with the fee proportional to the pollutant's toxicity—and these costs add up. For example, the external costs of sulfur dioxide pollution—including crop losses, building and monument corrosion, impaired visibility, and respiratory illnesses—may be more than $5,000 per ton.

Pollution fees that start small and gradually increase until they approximate the true costs of pollution would add economic teeth to the regulatory approach of current clean air and water laws. Pollution taxes matching the real cost of pollution could generate enough revenue to eliminate Oregon's corporate income tax, and encourage commerce, employment, and investment in goods and services that improve peoples' lives over generations.



**Factories and other sources of large quantities of pollution** are already regulated and most must track and report their emissions, so taxing their harmful emissions would not be a complicated administrative task. In the case of motor vehicles, officials could bill drivers in proportion to their emissions and miles driven, at the regular air-quality inspections already required in the Northwest's metropolitan areas.

Big polluters bearing more of the tax burden would allow small entrepreneurs and individuals to get a tax break. The growing service industry and other "clean" sectors would also benefit handsomely, while producers of negative externalities, such as pollution, would have a large incentive to innovate and invest in finding cleaner technologies. Increased demand for pollution reduction programs would further strengthen Oregon's already-robust green technology sector.

## Tax Sprawl

A different form of tax shifting, known as land-value taxation, would fashion the property tax into a powerful incentive for investment in city and town centers and adjacent neighborhoods. In Oregon, it could supplement or even replace some of the regulatory tools of land-use planning that Measure 37 has weakened.

A property tax is actually two conflicting taxes rolled into one: it's a tax on the value of structures and a tax on the value of the land under those structures. Taxing built structures discourages building; taxing land values encourages building, especially in urban centers, where land values are typically hundreds of times higher than in rural areas. Taxing urban and suburban sites but not buildings would spur development of the most valuable locations in developed areas. Parking lots, a common holding pattern for land speculators, would give way to buildings. Supplies of apartment and office space would increase and rental prices would moderate.

Lot-by-lot analysis in three counties, two in Washington and one in Oregon, suggests that a complete shift of the property tax off buildings would more than double taxes on parking lots and vacant lots, increase taxes by up to one-quarter on car-oriented commercial strip development, and moderately reduce taxes on pedestrian-oriented neighborhood shopping districts. It would lower taxes by about one-third on the most land-efficient forms of housing—apartments and condominiums—and by about 5 percent for most single-family residences, according to studies in King and Clark Counties, Washington.

Oregon already applies this logic in a few cases: To encourage construction of affordable multifamily housing, for example, Portland provides temporary exemptions from paying tax on the value of qualifying new buildings. The logic of taxing the land, but not what's on it, merits extension to all buildings, as occurred in western Canada between 1903 and 1913 and as it is now in Australia, Taiwan, and some Pennsylvanian cities.

*[In western Canada at the beginning of the 20th century, the land tax encouraged the building of everything from houses to grain elevators. The cost of World War I caused the local government to increase taxes on buildings-Ed]*

Jurisdictions can take an easy first step in this direction by giving localities authority to re-weight their property taxes between land and buildings. Cities could then exert leverage on their own to end speculation on parking lots, vacant land, and rundown, low-rise buildings, concentrating growth in city cores.

## Turbocharge fuel efficiency

A third tax shift that's ready for primetime is feebates—the novel combination of fees and rebates recently proposed by Oregon's Senator Smith. Feebates would continuously tug the entire car and truck market toward better fuel economy, creating incentives for both car makers and car buyers to embrace efficiency.

The debut of feebates is especially timely in Oregon because the Environmental Quality Commission of Oregon recently adopted Clean Car Standards, which help reduce transportation related greenhouse gas emissions in Oregon. Beginning in 2009, all new and used cars with less than 7,500 miles must follow these standards.

Feebates would help achieve this goal. The basic idea is elegant in its simplicity: Charge fees to the buyers of inefficient vehicles and refund the resulting revenue as rebates to the buyers of more efficient cars and trucks. In the state of Oregon, for example, the average new vehicle goes about 25 miles per gallon. Using a feebate system, these *average efficiency vehicles* would carry neither a fee nor a rebate. Each mile-per-gallon above (or below) average efficiency would award a rebate (or fee) to a buyer.

If the United States enacted a feebate on new cars that paid $70 for every mile-per-gallon above the average, new-car fuel economy would rise about one percent per year. (Kenneth Train of the University of California Berkeley and colleagues). As the new car fleet's average efficiency rises over time, the center point also ratchets upward, and both manufacturers and consumers have an incentive to set their sights higher—allowing fuel efficiency to snowball.

*[If the average fuel economy was 25 mpg and rose one percent per annum, it would take 30 years for the average mpg of the US fleet to reach 33 mpg-Ed]*

Tax shifting is still a new idea and new ideas take time to catch on in this anti-tax era. Fortunately, a tax shift can proceed in steps, each step strengthening the economy while helping the environment. In the end, the practical challenge is one of public education and political organizing. After all, we have much to lose—an underperforming job market, endangerment of the landscape, and tax laws that punish virtues while rewarding vices. With tax shifting we have much to gain: stronger communities, fairer markets, and better stewardship of nature and our democracy.

*[Many (industry for one) prefer cap and trade systems over tax shifting to reduce pollution. Critics of cap and trade point out that when companies can trade pollution credits, those who benefit are older less efficient companies who pollute the most. Carbon taxes, on the other hand, tend not to favor anyone with a historic right to pollute-Ed].*