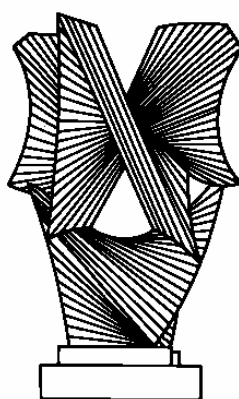


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Taxes and the Success of Non-Tax Market-Based Environmental Regulatory Regimes

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Environmental economists and policymakers often advocate market-based environmental regulatory regimes. While market-based regimes may be structured as Pigouvian taxes, other market-based regimes, such as tradable pollution permit regimes and conservation easements, rely upon private transactions in environmental degradation rights to achieve regulatory goals. In general, once the choice is made to adopt a non-tax-based regime, it is almost always the case that tax concerns are not discussed. Policymakers err, however, in viewing a choice against the use of an environmental tax regime as rendering tax concerns irrelevant. I argue that tax concerns, and tax structures, can have significant effects upon the function and ultimate success of non-tax market-based environmental regulatory regimes. To demonstrate this point, I consider the U.S. federal income tax treatment of two market-based environmental regulatory devices—conservation easements and tradable pollution emission allowances. In particular, I argue that the current income tax treatment may frustrate the environmental goals of the devices. For example, donating or selling a conservation easement may result in the deferral or even the elimination of gains or losses. While the possibility of deferring or eliminating a gain may encourage property holders to sell or donate conservation easements—a result presumably consistent with environmental goals—it is also true that the deferral or elimination of a loss may discourage property holders from selling or donating conservation easements. And there is little reason to think that the presence of an unrealized gain (or loss) with respect to a piece of property correlates to desirability of obtaining a conservation easement with respect to that property. As an example on the tradable emission allowance side, the rules for establishing the tax basis in grandfathered emission allowances actually work to discourage the trading of permits. However, trading is key to tradable emission allowance regimes achieving their promise—improvement in environmental quality at the lowest possible cost. Thus, the tax structure frustrates the market for allowances, and with it the environmental goals of the regime. The notion that the tax treatment of market-based environmental regulatory devices should be evaluated from the perspective of environmental policy does not mean that tax policy concerns should be ignored or compromised. Neither, however, should environmental policy concerns. Moreover, environmental and tax policy concerns should be aligned to the extent that that is possible.