German Economic Review 6(2): 255–257

Discussion

Does Money Illusion Rescue the Double Dividend?

Arij Lans Bovenberg
Center for Economic Research,
Tilburg University

Ruud A. de Mooij
Erasmus University,
Rotterdam

Reto Schleiniger shows that the introduction of money illusion in the simple analytical model contained in Bovenberg and de Mooij (1994a) turns the main result around: an environmental tax reform expands rather than contracts employment, thereby generating a double dividend.

The reason why Schleiniger derives a completely different result than we do is as follows. In our model, an environmental tax reform amounts to replacing an explicit labor tax by an implicit labor tax in the form of an environmental tax on the polluting good. The overall tax burden on labor increases as a result of this tax reform, thereby harming the incentives to supply labor. The intuition for a higher effective tax burden as a result of a revenue-neutral tax reform is that the tax reform raises the overall supply of public goods by increasing the quality of the environmental public good (see Bovenberg, 1999). In Schleiniger's model, in contrast, the higher pollution tax does not harm the incentives to supply labor because households base their labor supply decisions on the *nominal* wage rate rather than the *real* wage rate. Hence, whereas a cut in the labor tax raises the after-tax nominal wage and thus enhances the incentives to supply labor, the larger pollution tax does not harm labor-market incentives. Households ignore the adverse impact of higher pollution taxes on the spending power of additional labor income. Pollution taxes thus do not harm incentives on the labor market.

Schleiniger's result is reminiscent of the results for a slightly modified version of our model in which some consumption is out of transfer income (see Bovenberg and de Mooij, 1994b). If transfer income is indexed to producer rather than consumer prices, substitution of labor taxes by environmental taxes can raise employment. Intuitively, workers enjoy all the benefits from lower labor taxes and can shift some of the cost of higher environmental taxes onto transfer recipients. In this way, the real after-tax wage, on which workers base their labor supply decision, increases.