

Energy Taxes and the Pretense of Knowledge

by Roy Cordato

“[T]he current net tax per gallon [of diesel fuel] is 13 percent of the price, while the environmental cost per gallon is 50 percent of price.

The tax on this fuel could be raised substantially to promote its efficient use.”¹

Typically economists oppose excise taxes on the grounds that they distort market prices and lead to a misallocation of resources. But to most economists, energy, particularly energy that is derived from fossil fuels (coal, oil, and natural gas), is seen as an exception. In fact, as evidenced in the statement above, to the extent that the generation of energy imposes unwanted negative effects on society, such as pollution, it is argued that taxes on the production of that energy are called for to enhance the efficient operations of the market. In the face of a new “energy crisis” and increasing levels of propaganda about environmental problems, real and imagined, it is possible, with an assist from “economic science,” that “soak the energy wasters” could replace “soak the rich” as the number one rallying cry for new tax initiatives.

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Support for energy taxes by many economists centers on the economic concept of externalities. Because some energy production generates pollution, the full cost of generating that energy is not being borne by its producers and consumers: there are “external effects.” As a result the price of the energy source is said to be “too low” and the amount of it produced is said to be “too high”; the market “fails” to generate the “correct” output at the “correct” price. The standard solution is to tax the energy source to induce the producer to charge the “correct” price and produce the “correct” level of output. Such a tax would, according to the theory, improve economic performance of the economy overall. As one staunch supporter of energy and other externality taxes has argued: “The primary function of such taxes is to make the economy function more efficiently. Through their use we have the opportunity to employ the tax system, not only to raise revenues but also to enhance the operations of the economy.”²

There are serious flaws in this entire approach to both environmental and tax policy. Ultimately we must ask what is meant by market failure and, implicitly, market success. If certain forms of energy are being sold at the wrong prices and are being produced in the wrong amounts, what would be the correct price and output? Obviously this would have to be known before a tax that would “enhance the operations of the economy” could be formulated and imposed. When all the fancy terminology, graphs, and equations are stripped away,

the definition of market success that energy tax policymakers are supposed to mimic is so stylized and so contrived as to have no relevance for real-world policymaking.

Knowledge Problems and the Correct Price and Output

The “correct” price and output from this perspective is the one that would be generated under conditions of what is called “perfect competition.” This is a world where all market participants have perfect knowledge of all current and future information that relates to their market activities. Within product lines there are no differences between what competitors offer for sale. Markets can be entered and exited costlessly. Finally, there are so many buyers and sellers in any market that no one can have any effect on their selling or buying price. Furthermore, this world is static. Any unanticipated changes in people’s preferences, attitudes, technology, or the relative scarcity of resources are assumed away. The correct price and output is the one that will occur when *all* markets are operating under these conditions. So when an economist proclaims that “too much” gasoline is being consumed and, implicitly, that the price of gasoline is too low, he means: relative to the amount that would be consumed and the price that would be paid in a world that looks like the perfectly competitive model. Clearly, by this totally unrealistic and unobtainable standard, all markets fail all of the time.

Once this is recognized, the absurdity of the market-failure case for energy taxes becomes easily recognized. The information requirements that are necessary to impose the “efficiency enhancing” tax are so great as to render the policy impossible to implement. If the desired outcome is the one that will be obtained when all market participants have perfect information of all preferences, scarcities, and technologies, then any policymaker would have to have similarly perfect knowledge. In reality, then, the amount of the tax and the amount of the output reduction that it brings about would necessarily be arbitrary or politically motivated and unrelated to true efficiency considerations.

The market-failure argument for energy taxes, and energy policy in general, is based on what Nobel laureate F. A. Hayek described as a “pretense of knowledge.”³ To implement a tax policy that would improve on market results, the government would have to pretend that it had information it could not possibly possess. For example, gasoline taxes are often argued for on market-failure grounds. Because, it is assumed, the cost of air pollution is not being borne by oil companies and automobile drivers and producers, it is argued that too much gasoline is consumed and the price of gasoline is too low.

What is typically left unstated is that it is too low relative to the amount of gasoline that would be produced and consumed in the idealized world of perfect competition. Simply to know whether this is the case, the government must know how much would be consumed in a world of perfect competition. The government has to have complete knowledge of all the purposes for which individuals in society are using gasoline and the relative importance that they place on those purposes. Furthermore it would have to possess accurate knowledge of the costs that the pollution generated by the gasoline usage imposes on all the individuals in the economy. Ultimately all of this information is subjectively determined and unknowable by outside observers, even economists.

The information requirement becomes even more intractable once the timeless feature of the perfectly competitive world is recognized. To impose the “correct” tax, individual preferences, scarcities—and therefore all costs and benefits—are assumed to be constant. If this were not the case the amount of the correct tax would always be changing as these variables change. But this is not the real world. As time passes, people’s preferences and scarcity conditions are continuously changing. Even if we (unrealistically) assume that one could gather the relevant information to impose the correct tax for a given moment, by the time the tax was actually imposed it would be completely out of date.

The argument against the possibility of efficient taxation is essentially the same argument made by Mises and Hayek against the

possibility of efficient, centralized control of economies in general.⁴ Gerald O'Driscoll and Mario Rizzo refer to the implementation of such taxes as "socialism writ small."⁵ If a central authority could obtain the appropriate information for improving on market outcomes with regard to levying pollution- and energy-related taxes, then there is no reason why the same authority could not second-guess the market in general. Because of the nature of the information requirements needed to mimic the perfectly competitive results, the central authority would need to know the pattern of these outcomes in all markets, both for a particular moment and as time passes and information changes.

Insurmountable Problems

These kinds of information problems are insurmountable. In spite of this fact, highly respected economists continue to make bold proclamations concerning the appropriate size of such taxes and their effect on the efficient allocation of resources, as evidenced by the statement at the outset of this essay.

The fact is that energy taxes—like all other excise taxes—distort market efficiency, not enhance it. They drive a wedge between prices paid by consumers and those received by producers, with consumers paying more than they would in the absence of these taxes and

producers receiving less. Since energy is an input into production processes throughout the economy, this means that everyone's production costs are higher, and output and social welfare are lower.

In addition, such taxes, like all taxes, transfer resources from private to inherently less-efficient public-sector uses, further reducing output and productivity. That is rarely considered by those who claim that energy taxes enhance economic efficiency.

The packaging of energy taxes as good for the economy is a political ploy meant to give tax increases a free ride on the environmentalist bandwagon. We should never be more wary than when anyone, politician or economist, tells us that a tax is "for your own good." Taxes have one overriding purpose: to transfer resources from the private to the public sector. This has never been and cannot be a formula for improving the economy. □

1. W. K. Viscusi, "Pricing Environmental Risks," Policy Study No. 112, Center for the Study of American Business, 1992, p. 2.

2. Wallace Oates, "A Pollution Tax Makes Sense," in Herbert Stein, ed., *Tax Policy in the Twenty-First Century* (New York: John Wiley and Sons, 1988), p. 254.

3. F. A. Hayek, "The Pretense of Knowledge," in *New Studies in Philosophy, Politics, Economics and the History of Ideas* (Chicago: University of Chicago Press, 1978), pp. 23–34.

4. See Ludwig von Mises, *Socialism* (Indianapolis, Ind.: Liberty Fund, 1981[1922]) and F. A. Hayek, "Socialist Calculation I," "Socialist Calculation II," and "Socialist Calculation III" in *Individualism and Economic Order* (Chicago, Ill.: University of Chicago Press, 1948).

5. Gerald O'Driscoll and Mario Rizzo, *The Economics of Time and Ignorance* (Oxford: Basil Blackwell, 1985), p. 141.

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