

WORKING PAPER

Environmental Levies and Distortionary Taxation:  
Pigou, Taxation, and Pollution

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Discussion Paper 2000-04  
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January 13, 2000

Abstract

Bovenberg and de Mooij (1994) showed that, in the presence of preexisting distorting taxes, the optimal pollution tax typically lies below social marginal damages. The authors view this result as a refutation of the so-called "double dividend hypothesis," which suggests that a tax on pollution can both improve the environment and reduce distortions in the tax system. Their paper spawned a large literature on optimal environmental tax rates in a second-best world.

In this note, I argue that the emphasis on tax rates is misguided. Using an analytical general equilibrium model, I show that for reasonable parameter values, an increase in tax distortions (arising from an increase in required tax revenues) leads to a fall in the optimal Pigouvian tax while environmental quality improves. In general, knowledge of the direction of changes in optimal environmental tax rates due to changes in the economy is not sufficient for understanding the impact on environmental quality.

JEL No: H21, H23, Q28

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I appreciate comments from A. Lans Bovenberg and Don Fullerton on an earlier version of this note. I am also grateful for support from a National Science Foundation grant (SBR-9811324) through the National Bureau of Economic Research.

## I. Introduction

The double dividend hypothesis suggests that a tax on pollution can both improve the environment and reduce distortions in the tax system. In an important article, Bovenberg and de Mooij (1994) reframed the hypothesis as a question of whether the optimal tax on pollution in a second best world is higher or lower than the social marginal damages of pollution. In that paper, they "demonstrate that, in the presence of preexisting distorting taxes, the optimal pollution tax typically lies below the Pigovian tax, which fully internalizes the marginal social damage from pollution" (p. 1085).

I argue in this note that the focus on tax rates is misguided.<sup>1</sup> A more important issue is the relation between the level of tax distortions in the economy and environmental quality. Moreover, knowing that the optimal pollution tax falls below social marginal damages does not imply that environmental quality falls in the presence of preexisting tax distortions. In effect, we should distinguish between "price" questions and "quantity" questions. The price question refers to tax rates while the quantity question refers to environmental quality. Framed this way, this note evokes Atkinson and Stern (1974) and their analysis of public good provision in a second best world. That paper first shows how the Samuelson Condition for pure public goods is affected by the presence of distortionary taxes (a "price" question). It then shows how the optimal provision of the pure public good is affected by distorting taxes (a "quantity" question). A key message in that paper is that answering the question of how the Samuelson Condition changes tells us nothing about the optimal provision of the public good. This

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<sup>1</sup> The emphasis on tax rates can also be found in a number of papers that followed Bovenberg and de Mooij, including Fullerton (1997), Schob (1997), and Jaeger (1999).

note gives a similar message in the environmental policy arena (hence the sub-title of the note).

Specifically, I show that the optimal environmental tax component of a commodity tax on a polluting good falls short of social marginal damages and that the environmental tax component falls as revenue needs (and hence tax distortions) rise. These "price" results might lead one to believe that environmental quality should fall as revenue needs rise. (One might also draw this conclusion from Bovenberg and de Mooij when they note that "high costs of public funds crowd out not only ordinary public consumption, but also the collective good of the environment" (p. 1088).) This turns out to be incorrect. I show that the response of environmental quality to an increase in revenue requirements depends on two effects: a substitution effect as consumers substitute from clean to dirty goods as the environmental tax component falls and an output effect as consumers substitute from purchased commodities to leisure (a clean good). For all reasonable parameter values, I find that the output effect dominates the substitution effect so that an increase in required revenues improves the environment while simultaneously reducing the optimal Pigouvian tax increment.

## II. The Model

Following Bovenberg and de Mooij, I employ a linear production technology in which labor ( $L$ ) is used to produce a clean good ( $C$ ), a dirty good ( $D$ ), and government services ( $G$ ). Government services can be either clean or dirty and I assume that the fraction of services that contribute to pollution is constant and equal to  $\alpha$ . The economy has  $N$  identical people and labor productivity equals  $h$ . Since each good is produced using one unit of labor, the technology is

$$(1) \quad NhL = NC + ND + G.$$

Utility is a function of the two goods and government services as well as leisure (V) and environmental quality (E):

$$(2) \quad U = u(C, D, V; G, E)$$

where environmental quality is a function of the aggregate production of the dirty good plus G:  $E = e(ND + G)$ , with  $e' < 0$ . Individuals maximize utility subject to a time constraint ( $V + L = 1$ ) and a budget constraint:

$$(3) \quad hL = (1 + t_C)C + (1 + t_D)D$$

where  $t_C$  is a tax on C and  $t_D$ , a tax on D. The social marginal damage of pollution in dollar terms is the marginal damage divided by the private marginal utility of income ( $\lambda$ ):

$$(4) \quad \tau = -\frac{\partial U}{\partial E} e' N / \lambda.$$

As in Fullerton (1997), I first solve for optimal tax rates conditional on some level of required government services (G). I totally differentiate the utility function, plug in the first order conditions from the household's utility maximization problem and the resource constraint ( $dL = dC + dD$ ) and obtain a measure (in income) of the welfare gain from increasing  $t_D$  while the tax rate on C is reduced to keep total tax revenues constant:

$$(5) \quad dU/\lambda = t_C dC + (t_D - \tau) dD$$

Setting (5) equal to zero and solving for the optimal tax rate on D, we get<sup>2</sup>

$$(6) \quad t_D^* = \tau + \left( -\frac{dC}{dD} \right) t_C^*$$

Perturbing the tax rates will generate changes in all the variables in a general equilibrium. Thus, we need a complete model in order to determine the changes in C and D to obtain a closed form solution for the relation between  $t_C^*$  and  $t_D^*$  in equation (6).

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<sup>2</sup> This is equation (9) in Fullerton (1997).

First consider the consumer response to changes in prices. Following the approach taken by the previous authors, I assume a subutility function for C and D that is homothetic and weakly separable from leisure. Let this function be  $Q(C,D)$ . With this assumption, I can characterize the preference for C and D in terms of the elasticity of substitution in consumption ( $\sigma$ ):

$$(7) \quad \hat{C} - \hat{D} = \sigma(\hat{t}_D - \hat{t}_C)$$

where  $\hat{X} = \frac{dX}{X}$  and in the case of the tax variables,  $\hat{t} = \frac{dt}{1+t}$ . In other words,  $\hat{t}$  is the

change in tax as a percentage of the consumer price. The consumer price for C ( $p_C$ ) equals  $1+t_C$  and  $\hat{t}_C = \hat{p}_C$  (similarly for  $p_D$ ). Labor is taken to be the numeraire with a fixed gross wage of  $h$  and a real wage of  $w=h/p_Q$ , where  $p_Q$  is a price index on the consumption bundle  $Q(C,D)$ . Labor supply is related to the real wage by the uncompensated labor supply elasticity ( $\epsilon$ ):

$$(8) \quad \hat{L} = \epsilon \hat{w} .$$

The percentage change in the real wage depends on the change in tax rates:

$$(9) \quad \hat{w} = -\phi \hat{t}_C - (1-\phi) \hat{t}_D$$

where  $\phi$  is the share of consumer spending on the clean good.

Next, we turn to the government's budget constraint. Fixed government spending ( $G$ ) is financed by taxes on the  $N$  identical households in the economy:

$$(10) \quad t_C C + t_D D = G/N$$

Differentiating (10) and keeping the level of  $G$  fixed, we obtain

$$(11) \quad \phi(\hat{t}_C + \theta_C \hat{C}) + (1-\phi)(\hat{t}_D + \theta_D \hat{D}) = 0,$$

where  $\theta$  is the tax expressed as a fraction of the consumer price (e.g.  $\theta_C = t_C/(1+t_C)$ ). The final equation follows from differentiating the overall resource constraint (1) and defining production shares  $\pi_C = C/hL$  and  $\pi_D = D/hL$ :

$$(12) \quad \hat{L} = \pi_C \hat{C} + \pi_D \hat{D}.$$

Equations (7) - (12) are five equations from which we can solve for  $\hat{C}$ ,  $\hat{D}$ ,  $\hat{L}$ ,  $\hat{w}$ , and  $\hat{t}_C$  as functions of  $\hat{t}_D$ .

Some straightforward algebra leads to the general equilibrium response of C and D to a change in the tax on the dirty good:

$$(13) \quad dC = \frac{\sigma(1-\varepsilon t_D)(p_C C + p_D D)D}{p_C C(1-\varepsilon t_C) + D(p_C(1-\varepsilon t_D) + \sigma(t_D - t_C))} \hat{t}_D$$

$$(14) \quad dD = -\frac{\sigma(1-\varepsilon t_C)(p_C C + p_D D)D}{p_C C(1-\varepsilon t_C) + D(p_C(1-\varepsilon t_D) + \sigma(t_D - t_C))} \hat{t}_D$$

Substituting (13) and (14) into (6) yields a simple expression for the relationship between the optimal tax rates on C and D:<sup>3</sup>

$$(15) \quad t_D^* = t_C^* + (1 - \varepsilon t_C^*)\tau.$$

Before turning to the two questions posed in the introduction, it is worth examining equation (15) and noting the following. First, if environmental tax revenues are sufficient to cover government expenses, then a tax on the clean good is unnecessary. In this case, the tax on D (as well as the difference,  $t_D - t_C$ ) exactly equals  $\tau$ . This is the Pigouvian rule in a first-best situation. Even if a tax on C is required, the first best rule still holds so long as  $\varepsilon$  equals zero. Second, if neither of these conditions hold, then the Pigouvian tax

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<sup>3</sup> Equation (15) and the government budget constraint will pin down both tax rates. We are only concerned here with the Pigouvian tax increment  $t_D - t_C$ .

increment  $(t_D^* - t_C^*)$  falls short of  $\tau$ .<sup>4,5</sup> This confirms Bovenberg and de Mooij's result but avoids any possible confusion that might arise from implicit taxation of the dirty good through a tax on labor. Third, we can recharacterize (15) in terms of the partial-equilibrium marginal cost of public funds for a labor tax ( $\phi$ ) as defined by Goulder and Williams (1999), page 7. Fullerton, Hong, and Metcalf (1999) show that

$$(16) \quad \psi = \left[ 1 - \left( \frac{t_L}{1-t_L} \right) \epsilon \right]^{-1}$$

when a tax on labor is used. The model in this paper does not employ a tax on labor but rather taxes on the two commodities. We can renormalize the system so that C is the untaxed good and labor supply is taxed by dividing the consumer budget constraint by

$$1+t_C \text{ and defining a tax on L by the relation } 1-t_L \equiv \frac{1}{1+t_C}. \text{ Thus, } t_C = \frac{t_L}{1-t_L}.$$

Substituting this relation into (16) yields  $\phi = (1-\epsilon t_C)^{-1}$  and so equation (15) can be rewritten as

$$(15') \quad t_D^* - t_C^* = \frac{\tau}{\psi} < \tau.$$

The Pigouvian tax increment equals social marginal damages divided by the partial equilibrium marginal cost of public funds.<sup>6</sup>

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<sup>4</sup> I presume throughout that  $1-\epsilon t_C$  lies between zero and 1.

<sup>5</sup> Equation (15) can be related to the optimal tax on a polluting good in the presence of a labor tax. Fullerton, Hong, and Metcalf (1999) show in their equation (23) that if  $t_C$  is set to zero and a tax on L used instead, then  $t_D^* = \left( 1 - \left( \frac{t_L}{1-t_L} \right) \epsilon \right) \tau$ , where  $t_L$  is the labor tax. With no tax on the clean good,  $t_D$  is the

Pigouvian tax increment and  $t_L/(1-t_L)$  is simply the labor tax re-expressed as a uniform commodity tax. In other words, equation (23) in Fullerton, Hong, and Metcalf is essentially the same as equation (15) here.

<sup>6</sup> See Bovenberg and van der Ploeg (1994) for an equivalent derivation in the case where a tax on labor and the dirty good are employed.

### III. Analysis

Imagine that the government needs to raise additional distortionary tax revenues to finance an expansion of government services. A natural question to ask is what happens to the difference between the Pigouvian tax increment ( $t_D^* - t_C^*$ ) and social marginal damages ( $\tau$ ), a "price" question, as noted in the introduction.<sup>7</sup> An early reading of the Double Dividend literature might suggest that this increment should rise as revenue needs rise.<sup>8</sup> As we shall see, this supposition is incorrect. That the Pigouvian tax increment falls suggests that the increase in required government revenues will lead to a dirtier environment (a "quantity" question), a concern presumably of greater interest to environmentalists than tax rates, per se. On the contrary as I'll show below, the increase in required revenues should lead to a cleaner environment.

Let me now turn to this policy experiment and these two questions.<sup>9</sup> Specifically, I investigate how an increase in required distortionary taxes to finance an increase in  $G$  changes 1) the Pigouvian tax increment ( $t_D^* - t_C^*$ ) and 2) environmental quality ( $E$ ). The diversion of resources from the private to the public sector directly affects the environment to the extent that the fraction of dirty public services relative to total government purchases differs from the fraction of dirty private goods relative to total

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<sup>7</sup> I treat  $G$  as an exogenous parameter while the tax rates are set in an optimal fashion. In other words, some political process leads to a choice of  $G$  and conditional on that choice, tax authorities set tax rates to minimize deadweight loss.

<sup>8</sup> For example consider this quotation from Repetto and others (1992): "Taxes on these environmentally damaging activities [resource waste, pollution, and congestion] would not distort economic decisions, but rather would correct existing distortions" (page 2). Following this logic, the greater the distortion, the higher the tax rates on polluting activities.

<sup>9</sup> In a recent paper, Gaube (1998) considers a slightly different experiment. He compares environmental quality in a first-best relative to a second-best optimum and finds that environmental quality is higher in the second-best optimum. To obtain this result, he restricts utility to be quasi-linear in private consumption, leisure, the government good, and the environment. This restriction is stronger than the restrictions on preferences in this model. Moreover, his model does not address the question of the impact of increased tax distortions on environmental quality.

private goods ( $D/(C+D)$ ). For example, if  $\gamma$  equals zero, the expansion of government services will likely lead to a cleaner environment since the government output has no impact on the environment. To avoid this demand side effect, I assume that government spends its revenue on the same mix of clean and dirty goods as does the private economy.<sup>10</sup> In other words, dirty government output is a fraction of  $G$  equal to

$$(17) \quad \gamma G \equiv \frac{\pi_D}{\pi_C + \pi_D} G.$$

Environmental quality will increase if  $N\hat{D} + \hat{G}$  decreases or equivalently if

$$(18) \quad (1 - \pi_G)\hat{D} + \pi_G\hat{G} < 0$$

where  $\pi_G = G/NhL$  and  $\pi_C + \pi_D + \pi_G = 1$ .

For the purposes of measuring the general equilibrium effects of an increase in  $G$ , equations (7), (8), and (10) continue to hold. Equation (11) now becomes

$$(11') \quad \phi(\hat{t}_C + \theta_C\hat{C}) + (1 - \phi)(\hat{t}_D + \theta_D\hat{D}) = \pi_G\hat{G}.$$

Equation (12) becomes

$$(12') \quad \hat{L} = \pi_C\hat{C} + \pi_D\hat{D} + \pi_G\hat{G}.$$

Finally, conditional on  $G$ , equation (15) relating the optimal taxes on the clean and dirty goods continues to hold. Differentiating this equation yields

$$(19) \quad \hat{t}_D = (1 - \varepsilon\tau) \left( \frac{1 + t_C}{1 + t_D} \right) \hat{t}_C.$$

These six equations can be solved for changes in  $C$ ,  $D$ ,  $L$ ,  $t_C$ ,  $t_D$ , and  $w$  as functions of  $\hat{G}$ .

Let me first consider the question of the impact of an increase in  $G$  on the Pigouvian tax increment. From equation (15) we see that

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<sup>10</sup> This is the approach taken in Harberger (1962) to rule out demand side effects in his classic analysis of

$$(20) \quad d(t_D - t_C) = -\varepsilon \tau dt_C$$

and the Pigouvian tax increment will fall if the tax rate on C rises as G increases.

Rewrite (15) as  $t_D^* = \tau + (1 - \varepsilon \tau) t_C^*$  and note that the sign of  $dt_D$  equals the sign of  $dt_C$  if  $1 - \varepsilon \tau > 0$ . With a high range estimate of  $\varepsilon$  equal to 0.5, this inequality will be positive so long as  $\tau < 2$ , or that the social marginal damages of pollution do not exceed twice the production cost of the dirty good. I'll assume that this condition holds.<sup>11</sup> If we rule out any Laffer tax effects, then  $\text{sgn}(dt_D) = \text{sgn}(dt_C) = \text{sgn}(dG) > 0$ . With  $dt_C > 0$ , equation (20) indicates that the Pigouvian tax increment falls as G rises (so long as  $\varepsilon > 0$ ). An increase in required distortionary tax revenues does not favor increased taxation of the dirty good relative to the clean good.

The intuition underlying this result is quite simple. Sandmo (1975) showed that the optimal tax on a polluting good is a weighted average of a Ramsey component and marginal environmental damages. As government revenue needs increase (and so the marginal cost of public funds increases), the weight on the Ramsey component rises and the weight on the environmental component falls. With separability between leisure and consumption goods, the optimal Ramsey components on the two goods are equal. Thus an increase in the Ramsey weight leads to a decrease in the difference between the two tax rates (i.e. the Pigouvian tax increment).

Having answered the "price" question, I now turn to the "quantity" question.

Recall that environmental quality rises if  $(1 - \pi_G) \hat{D} + \pi_G \hat{G} < 0$  (equation (18)). Some simple manipulation of the six equations in our system shows that

$$(21) \quad (1 - \pi_G) \hat{D} + \pi_G \hat{G} = \pi_C \sigma(\hat{t}_C - \hat{t}_D) + \hat{L}.$$

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the incidence of the corporate income tax. I thank Don Fullerton for suggesting this approach.

Thus,  $dE > 0 \Leftrightarrow \pi_C \sigma (\hat{t}_C - \hat{t}_D) + \hat{L} < 0$ . The first term on the right hand side of (21) is positive since the Pigouvian tax increment falls,<sup>12</sup> and the second term is negative since labor supply falls in response to the lower real wage. The first term is a substitution effect. As the Pigouvian tax increment falls, consumers will substitute from C to D. The strength of this effect depends on the elasticity of substitution in consumption ( $\sigma$ ). The substitution effect will work towards reducing environmental quality. The second term is an output effect and reflects the fact that the increase in taxation will lead to a substitution away from both produced goods towards leisure. Since leisure is a clean commodity, this effect serves to improve environmental quality. Whether an increase in government spending financed by increased taxes leads to a fall or rise in environmental quality depends on the relative size of the substitution and output effects.<sup>13</sup>

To get a feel for the relative importance of the substitution and output effects, consider the following numerical example. Assume an economy with the following characteristics.<sup>14</sup>

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<sup>11</sup> This condition also ensures that  $t_D > \tau$  (see Schob (1997) for an argument that this will hold).

<sup>12</sup>  $\hat{t}_D = (1 - \varepsilon \tau) \left( \frac{1 + t_C}{1 + t_D} \right) \hat{t}_C \equiv \Omega \hat{t}_C$  where  $\Omega < 1$  since  $t_D > t_C$  and  $1 - \varepsilon \tau < 1$ . Thus

$\hat{t}_D - \hat{t}_C = (\Omega - 1) \hat{t}_C < 0$ .

<sup>13</sup> Bovenberg and van der Ploeg (1994) carry out a similar exercise and derive an equation similar to equation (21). See Table 4 in that paper. The advantage of this derivation is that 1) it abstracts from any demand side effects, 2) the formula is considerably more transparent, and 3) I can easily provide some numerical results to show the relative magnitude of the two effects (see below).

<sup>14</sup> See Fullerton and Metcalf (1997) for a justification for these assumptions.

<b>Parameter</b>	<b>Value</b>
$\varepsilon$	0.30
$\tau$	0.30
$\pi_C$	0.30
$\pi_D$	0.40
$\pi_G$	0.30
$\sigma$	1.0

With these parameter values, the optimal tax rates are  $t_C^* = 0.27$ ,  $t_D^* = 0.55$ , and the Pigouvian tax increment is  $0.28 < \tau$ . Now consider a 10 percent increase in required government revenue. The substitution effect then equals 0.005 and the output effect equals -0.015, so the total effect is -0.010. In other words, the 1.5 percent fall in labor supply will more than offset the substitution effect, and pollution falls by 1 percent. Table 2 presents a range of estimates of the impact of a 10 percent increase in required revenue on pollution, for differing values of  $\sigma$  and  $\varepsilon$ :

		$\varepsilon$		
		<b>0.15</b>	<b>0.30</b>	<b>0.45</b>
$\sigma$	<b>0.5</b>	-0.005	-0.012	-0.021
	<b>1.0</b>	-0.003	-0.010	-0.018
	<b>2.0</b>	0.000	-0.006	-0.013

Only in the case of an elasticity of substitution equal to 2 combined with a low labor supply elasticity (0.15) does the increased revenue requirement fail to reduce pollution. In all other cases, pollution falls between .3 and 2.1 percent.

#### **IV. Conclusion**

This note has accomplished two goals. First, it has confirmed in a simple model that the optimal incremental tax on pollution lies below social marginal damages with pre-existing distorting taxes and that the optimal environmental tax increment falls as

government revenue needs rise. Second, I have shown that an increase in government revenue needs has two offsetting impacts on the environmental quality. For all reasonable parameter values, environmental quality improves despite the decrease in the Pigouvian tax increment.

This result evokes Atkinson and Stern's analysis of public good provision in a second best world. The first part of their paper focused on how the Samuelson Condition for pure public goods is altered in the presence of distortionary taxation. That question is analogous to the current focus on the relationship between the environmental tax increment ( $t_D - t_C$ ) and social marginal damages ( $\tau$ ). Atkinson and Stern then pointed out that answering the question of how the Samuelson Condition changes (a price question) tells us nothing about the optimal provision of the public good (a quantity question). Similarly here. Learning that the optimal tax increment falls increasingly short of social marginal damages as the need for distortionary taxes rises does not imply that environmental quality must fall as revenue needs increase. On the contrary, a quite plausible result is a cleaner environment. In short, the focus on tax rates is misleading and attention should be paid to how pollution itself is altered by changes in the need for distorting taxes.

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