Understanding the Inequality and Welfare Impacts of Carbon Tax Policies

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Abstract

This paper develops a general equilibrium lifecycle model to explore the welfare and inequality implications of different ways to return carbon tax revenue back to households. We find that the welfare-maximizing rebate uses two thirds of carbon-tax revenue to reduce the distortionary tax on capital income while using the remaining one third to increase the progressivity of the labor-income tax. This recycling approach attains higher welfare and more equality than the lump-sum rebate approach preferred by policymakers as well as the approach originally prescribed by economists – which called exclusively for reductions in distortionary taxes.

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Email: stephie.fried@sf.frb.org, knovan@ucdavis.edu, william.b.peterman@frb.gov. The views expressed in this paper are our own and do not reflect the views of the Federal Reserve System or its staff. For helpful comments, we thank seminar and conference participants at AERE, Fordham University, UPenn, the CESifo Conference on Environmental Economics, SURED, the Konstanz Seminar, and the NBER climate policy and inequality pre-conference. All potential errors are our own. Declarations of interest: none. This paper was previously circulated under the title "Recycling Carbon Tax Revenue to Maximize Welfare."

1 Introduction

While past efforts to implement a federal carbon price in the U.S. have failed, there is growing support for pricing carbon among policymakers. Indeed, from 2019 through 2021, fourteen different carbon tax bills were introduced in Congress.[1] On the surface, these bills are quite similar. Nearly all propose a tax starting in the range of \$25 to \$50 per ton of CO_2. Moreover, most call for the majority of the revenue to be recycled back to households. However, there is no clear consensus on how to recycle the revenue back to households. Many proposals call for the revenue to either be returned through tax swaps or periodic, lump-sum payments (i.e. carbon dividends). Others instead propose a more targeted approach intended to achieve a more progressive outcome – returning the revenue through income-tested payments. The objective of this paper is to provide guidance surrounding which recycling options to use to maximize welfare.

Drawing on an approach from the macro public finance literature (e.g., Conesa et al. (2009), Heathcote et al. (2017)), we search for the welfare-maximizing way to recycle carbon-tax revenue in a general equilibrium heterogeneous agent model of the U.S. economy. We calibrate the model to not only reflect heterogeneity across agents and their lifecycles, but also to match several important features of the U.S. economy, including the current tax system and the importance of energy in the production of the final good and also in utility. Consistent with the wide array of recycling approaches included in the existing policy proposals, we consider all convex combinations of tax swaps (i.e. uniform reductions in the labor or capital income tax rates), lump-sum payments, and targeted rebates that vary with income. Importantly, we allow these targeted rebates to vary not only with total household income, as many current proposals call for, but also as a function of labor income. Measuring social welfare behind the veil of ignorance, we solve for the revenue recycling approach, or combination of approaches, that maximizes the expected lifetime welfare of an agent born into the future steady-state.[2]

[1] In August 2022, the US Government passed the Inflation Reduction Act which included a number of provisions to reduce US carbon emissions. The bill includes approximately \$370 billion in subsidies for clean technologies and is projected to reduce U.S. emissions by and additional 10-15 percentage points by 2030 (DOE 2022). Even so, the emissions reductions from the bill fall far short of the Biden administration's target of 50 percent reduction in emissions by 2030. Attaining this target will require additional and much stricter policies, potentially in the form of a carbon price.

[2] Following much of the literature studying revenue-recycling options, we do not model the environmental benefits from carbon tax policies. Rather, we focus on the non-environmental welfare consequences. In addition, we focus exclusively on modeling income heterogeneity, abstracting from heterogeneity across other dimensions (e.g., spatial heterogeneity). Recent work by Cronin et al. (2019) explores the potential redistributional impacts of a carbon tax policy within income groups. Moreover, Cavalcanti et al. (2021)

We find welfare is maximized by recycling revenue back to households using two distinct methods. Two thirds of the revenue is used to reduce the marginal tax rate on capital income and the remaining one third is used to increase the progressivity of labor tax. The importance of the capital tax rebate is not a new insight but is instead consistent with a large literature – dating back to the original 'double-dividend' studies (Parry (1995), Goulder (1995), de Mooij and Bovenberg (1998), Bovenberg (1999)) – highlighting that efficiency gains are achieved by using revenue from Pigouvian taxes to reduce distortionary taxes. The key new insight from our analysis is that welfare is maximized by using the remaining revenue to increase the progressivity of the overall policy, instead of uniformly lowering an existing tax. We find that these optimal rebate methods do not depend on the sub-optimal mix of income taxes we begin with and they are robust across a wide range of carbon tax levels and specifications for the utility function. Moreover, we find that the transitional welfare impacts are similar to the steady state welfare impacts, demonstrating that the optimal policy does not maximize the welfare of future cohorts at the expense of larger welfare losses for the current, living cohorts.

Returning to the recent surge of carbon tax proposals, there is clearly growing support among policymakers for recycling the revenue back to households through direct payments that are either uniform across individuals or varying inversely with a household's total income. One reason that these direct payments are more politically palatable is because they are progressive. Even if the payments do not vary across agents, they still make up a larger share of total income for lower income agents, generating higher welfare benefits for this group. Consistent with these policy proposals, we find that it is welfare-maximizing to use a sizable portion of the revenue to increase the progressivity of the policy. However, we find that varying the payments with a household's total income is not an effective way to increase equity. Instead, we show that using the revenue to increase the progressivity of the labor income tax achieves far higher equity and welfare than payments that are uniform or vary with a household's total income.

Intuitively, returning carbon tax revenue through an increase in the progressivity of the labor income tax directs revenue back towards working-age agents with low labor income. In contrast, recycling the revenue through payments that vary inversely with total household income directs revenue back towards any agents, working or retired, with low total income in that period. From an equity perspective, the ideal revenue recycling method would return the revenue to the agents with the highest marginal utility. Ultimately, labor income is more

examine the consequences across various countries with different amounts of dirty energy production.

closely correlated with marginal utility than total income because retirees have low total income but, since they are consuming their savings and social security benefits, this does not necessarily imply that they have high marginal utility. The key advantage of returning the revenue by increasing the progressivity of the labor tax is that it better targets the revenue to the highest marginal utility agents. Agents with lower labor income tend to have higher marginal utility because these agents either experienced an adverse income shock or are agents with lower labor income over their entire working lifetime.

The insights provided by our analysis stem from the combination of two modeling innovations. First, we don't restrict the recycling options to a small set of blunt approaches – e.g. returning revenue exclusively through lump-sum rebates, exclusively through a reduction in the capital income tax rate, or exclusively through a reduction in the labor income tax rate. Instead, we systematically consider a broad set of recycling options that includes combinations of different revenue-recycling instruments. Second, the quantitative overlapping generations model we construct incorporates heterogeneity on several dimensions that are crucial for quantifying the distributional and overall welfare consequences of a carbon tax. First, building on studies demonstrating that the welfare impacts of a carbon tax can vary across the lifetime and between individuals (e.g., Chiroleu-Assouline and Fodha (2014), Williams et al. (2015), Fried et al. (2018)), we model agents' entire lifecycle, generating heterogeneity over age, and include idiosyncratic shocks to labor productivity, generating heterogeneity over income within each age group. Additionally, we use Stone-Geary preferences to capture the fact that low-income agents use a higher fraction of their expenditures for energy (Metcalf (1999), Grainger and Kolstad (2010)).[3] While our model is designed to study distributional effects across income groups, it abstracts from distributional effects within income groups that would arise due to other dimensions of heterogeneity, such as geography, occupation or household size (Rausch et al. 2011, Pizer and Sexton 2020, Hänsel et al. 2022).

Stepping back, the analysis presented in this paper highlights the value of bringing the modeling tools from the macroeconomic literature to bear on a question traditionally studied by environmental and public economists. The macro public finance literature has long used general equilibrium, lifecycle models with rich within-cohort heterogeneity to quantify the welfare and distributional effects of alternative tax policies. This literature has primarily

[3] Recent work by Aubert and Chiroleu-Assouline (2019) and Jacobs and van der Ploeg (2019) also examine the welfare consequences of a carbon tax in models with income heterogeneity and homothetic preferences. Winter et al. (2021) studies the distributional effects of a carbon price in Canada across income groups under different revenue recycling approaches.

focused on which taxes to use to achieve a given revenue target. Instead, we focus on which taxes to decrease, given a new stream of revenue from a carbon tax, to satisfy the same revenue target. By using the macro modeling tools to incorporate heterogeneity, we are able to shed additional light on the welfare and distributional consequences of potential carbon tax policies.

The remainder of the paper proceeds as follows. Sections 2 and 3 present the model and discus how the model is calibrated to reflect the heterogeneity in the U.S. economy. Section 4 describes the set of revenue recycling options we study as well as the welfare measures we use to evaluate the policies. Section 5 identifies the welfare maximizing policy and then highlights why the optimal policy is preferred to a range of alternatives. Section 6 concludes.

2 Model

2.1 Demographics

Our model incorporates overlapping generations of agents. Agents enter the model when they start working, which we approximate with a real-world age of 20. Each period, agents age one year and a continuum of new 20-year-olds enters the model. The size of the new-born cohort grows exogenously at rate n. Agents make labor-supply and consumption decisions each period until they are forced to retire at a real-world age of 65. Retired agents finance consumption from Social Security payments and accumulated assets. Lifetime length is uncertain and mortality risk varies over the lifetime. Since individuals are uncertain how long they will live, they may die with positive asset holdings. We treat these assets as accidental bequests and redistribute them as lump-sum transfers T_t^a across individuals during period t.

2.2 Agents

Agents maximize the expected sum of discounted utility. We model agents as having time-separable preferences specified by:

$$U(\tilde{c}_{i,j,t}, h_{i,j,t}) = \frac{\tilde{c}_{i,j,t}^{1-\theta_1}}{1-\theta_1} - \chi \frac{h_{i,j,t}^{1+\frac{1}{\theta_2}}}{1+\frac{1}{\theta_2}}, \tag{1}$$

where $\tilde{c}_{i,j,t}$ represents the level of a composite good consumed by agent i, at age j, during period t and $h_{i,j,t}$ represents the hours worked. θ_1 is the coefficient of relative risk aversion and θ_2 is the Frisch elasticity of labor supply. χ determines the dis-utility of hours.

The composite good is comprised of a generic consumption good and carbon-emitting energy, capturing the fact that energy is not only used in production, but also directly by agents (e.g., gasoline). Previous work highlights that the share of expenditures that goes towards energy differs systematically across agents – with lower-income groups devoting a larger share of their budgets to energy (Metcalf (2007), Hassett et al. (2009)). Following Fried et al. (2018), we capture this negative relationship between income and energy budget shares by assuming that agents must consume a minimum amount of energy, $\bar{e}$, and that agents derive no utility from energy consumed up to this subsistence level. In particular, composite consumption is given by $\tilde{c}_{i,j,t} = c_{i,j,t}^{\gamma}(e_{i,j,t}^{c} - \bar{e})^{1-\gamma}$, where $c_{i,j,t}$ and $e_{i,j,t}^{c}$ denote the levels of the generic good and energy consumed, respectively.

Agents are endowed with one unit of time each period which they divide between labor and leisure. To generate a realistic distribution of income, we allow labor productivity to vary across agents and over time. In period t, at age j, agent i earns labor income $y_{i,j,t}^{h} \equiv w_t \cdot \mu_{i,j,t} \cdot h_{i,j,t}$, where w_t is the wage-rate, $h_{i,j,t}$ denotes hours worked, and $\mu_{i,j,t}$ is the agent's idiosyncratic productivity. Following Kaplan (2012), the log of an agent's idiosyncratic productivity consists of four additively separable components:

$$\log \mu_{i,j,t} = \epsilon_j + \xi_i + \nu_{i,j,t} + \pi_{i,j,t}. \tag{2}$$

ϵ_j governs age-specific human capital and evolves over the lifecycle in a predetermined manner. $\xi_i \sim NID(0, \sigma_{\xi}^2)$ is an agent-specific fixed effect observed when an agent enters the model. $\pi_{i,j,t} \sim NID(0, \sigma_{\pi}^2)$ is an idiosyncratic transitory productivity shock, and $\nu_{i,j,t}$ is an idiosyncratic persistent productivity shock which follows a first-order autoregressive process:

$$\nu_{i,j,t} = \rho \nu_{i,j-1,t-1} + \kappa_{i,j,t} \text{ with } \kappa_{i,j,t} \sim NID(0, \sigma_{\kappa}^2) \text{ and } \nu_{i,20,t} = 0. \tag{3}$$

To partially self-insure against productivity shocks and to finance consumption during retirement, agents can save by accumulating shares of physical capital, $a_{i,j,t+1}$, which they rent to firms at rate R_t. Capital accumulates according to the law of motion:

$$k_{t+1} = (1 - \delta)k_t + i_t,$$

where δ denotes the depreciation rate and variable i denotes new investment. We define $r_t \equiv R_t - \delta$ to be the agent's net rate of return. Working-age agents can borrow up to an exogenously-determined debt limit: $a_{i,j,t} \geq \underline{a}$.[4]

2.3 Firms

The final good, Y, is produced competitively from capital, K^y, efficiency labor, N^y, and carbon-emitting energy, E^y. The production technology is Cobb-Douglas between the three inputs:

$$Y_t = A_t^y (K_t^y)^{\alpha_y} (N_t^y)^{1-\alpha_y-\zeta} (E_t^y)^{\zeta}. \tag{4}$$

A^y denotes total factor productivity. In equilibrium, α_y and ζ equal capital's share and energy's share, respectively. The final good is the numeraire and can be used for consumption and investment. The specification in equation (4) implies that the economy can reduce fossil energy consumption by either reducing total production, or by substituting capital and labor for fossil-energy. Implicitly, this substituted capital and labor corresponds to non-carbon emitting energy or improvements in energy efficiency.

Carbon-emitting energy is produced competitively from capital, K^e, and efficiency labor, N^e, according to the production technology:

$$E_t = A_t^e (K_t^e)^{\alpha_e} (N_t^e)^{1-\alpha_e}. \tag{5}$$

In equilibrium, α_e equals capital's share in the production of energy.

2.4 Government

The government runs a balanced-budget, pay-as-you-go Social Security system and also raises revenue to finance an exogenous level of unproductive spending, G. The Social Security system is financed with a flat tax, τ^s, on labor income, up to a taxable maximum, $y^{h,max}$. In practice, the Social Security benefits provided to retired agents are a concave, piecewise linear function of each agents' average labor earnings over their highest 35 years of earnings. Instead of including an agent's whole history of labor earnings as an additional state variable, we follow Kindermann and Krueger (2012) and approximate lifetime labor earnings using agents' ability, ξ, and the value of the last realization of their persistent wage shocks, ν_{65}. Specifically, we compute $x(\xi, \nu_{65})$, the average lifetime labor earnings over the population, conditional on the ability and final persistent shock values. The social security benefit

[4] Agents borrow at the rate of r_t divided by their probability of surviving period t.

an agent of type (ξ, ν_{65}) receives during each period of retirement is determined using a piecewise-linear function of $x(\xi, \nu_{65})$ with marginal benefit rates, $\phi_i,\ i \in \{1, 2, 3\}$, given by:

$$\begin{aligned} &\phi_1 \text{ for } 0 \leq x < b_1 \\ &\phi_2 \text{ for } b_1 \leq x < b_2 \\ &\phi_3 \text{ for } b_2 \leq x < b_3. \end{aligned} \tag{6}$$

To finance spending G, the government can tax capital income, labor income, and, once a climate policy is adopted, carbon emissions. The government taxes an agent's capital income, $y^k_{i,j,t}$, according to a constant marginal tax rate τ^k. An agent's capital income is the return on her assets plus the return on assets she receives as accidental bequests, $y^k_{i,j,t} \equiv r_t(a_{i,j,t} + T^a_t)$.

Labor income is taxed according to a progressive tax schedule. An agent's taxable labor income is their labor income, $y^h_{i,j,t}$, net of her employer's contribution to Social Security which is not taxable. Thus, $\tilde{y}^h_{i,j,t} \equiv y^h_{i,j,t} - \tau^s \min(y^h_{i,j,t}, y^{h,max})/2$ is the agent's taxable labor income, where $\min(y^h_{i,j,t}, y^{h,max})/2$ is the employer's Social Security contribution. Following the quantitative public finance literature (Benabou (2002), Guner et al. (2014), Heathcote et al. (2017)), we use the following two-parameter function to model total labor income taxes for an agent with labor income $\tilde{y}^h_{i,j,t}$:

$$T^h(\tilde{y}^h_{i,j,t}) = \max\left[1 - \lambda_1 \left(\frac{\tilde{y}^h_{i,j,t}}{\bar{\tilde{y}}^h_t}\right)^{-\lambda_2}, 0\right] \tilde{y}^h_{i,j,t}, \tag{7}$$

where $\bar{\tilde{y}}^h_t$ is the mean value of taxable labor income in the economy. We bound the labor-tax function below at zero since we do not observe negative labor-income taxes in the U.S.

The function specified by equation (7) allows us to flexibly alter the labor tax following the introduction of a carbon tax. As long as the zero lower-bound does not bind, decreasing λ_1 decreases the after-tax labor-income of all individuals by the same percentage – leaving the distribution of after-tax income across agents unchanged. In contrast, changing λ_2 alters the distribution of after-tax labor income. Increasing λ_2 reduces the average tax rate for low-income households and increases the average tax rate for high-income households, reducing the inequality in the distribution of after-tax labor income.

With the introduction of a climate policy, the government can finance a portion of spending with a carbon tax, τ^c, levied on each unit of carbon-emitting energy consumed.[5] Using

[5]Given that fossil fuel combustion accounts for over 80 percent of GHG emissions, a carbon tax behaves much like a tax on energy. This abstracts from substitution between fossil fuel energy sources with varying

our model, we compare steady-state outcomes across a range of revenue-neutral carbon tax policies. The stationary competitive equilibrium, in which factor prices and aggregate macroeconomic variables are constant, is defined in Appendix A.

3 Calibration

We calibrate the model to match key features of the U.S. economy. We choose one set of parameters from the data and literature. The remaining parameters are set to ensure moments in the model match their values in the data. Appendix B discusses the data sources and summarizes the calibrated parameter values in greater detail.

3.1 Production

We normalize total factor productivity in energy and final-good production to unity, $A^e = A^y = 1$. Following Barrage (2019), we set capital's share in energy production equal to 0.597. Following Golosov et al. (2014), we set capital's share in the production of output equal to 0.3 and energy's share in the production output equal to 0.03. We choose the depreciation rate on capital equal to 0.079 to match the investment to output ratio of 23.3 percent.

3.2 Preferences

The discount rate $\beta = 0.995$ is chosen to match the U.S. capital-output ratio of 2.586. Disutility of labor $\chi = 73.3$ is chosen to ensure agents spend an average of one third of their time endowment working. Following Conesa et al. (2009), the coefficient of relative risk aversion, θ_1, equals two and following Kaplan (2012), the Frisch elasticity of labor supply, θ_2, equals 0.5. We choose the debt limit, $\underline{a} = -0.156$ to match the ratio of total debt (among individuals with debt) to total savings in the U.S. of 0.05. The conditional survival probabilities follow Bell and Miller (2002) and we impose a maximum age of 100.

Subsistence energy, $\bar{e}$, governs how an agent's energy budget share changes with income. Following Fried et al. (2018), we choose $\bar{e} = 0.0013$ to target the energy-share difference between the top and bottom halves of the expenditure distribution based on data from the CEX (see Appendix B). We also explore the sensitivity of the results across higher and lower values for $\bar{e}$. The expression $1 - \gamma$ represents fossil energy's share in the consumption-energy

carbon intensities that could occur with a carbon tax.

composite, $\tilde{c}$. All else constant, an increase in γ reduces energy's share in the consumption-energy composite and thus decreases the agent's demand for energy. We choose $\gamma = 0.9907$ to match the empirical ratio of energy consumed directly by households to total energy consumption, 0.183.

3.3 Idiosyncratic Labor Productivity

We take the parameters of the idiosyncratic labor productivity processes from Kaplan (2012): $\sigma_\xi^2 = 0.065, \sigma_\kappa^2 = 0.017, \sigma_\pi^2 = 0.081$ and $\rho = 0958$.[6] Importantly, the annual variation in labor income that Kaplan (2012) uses to estimate the shock processes includes heads of households who have worked as little as one-quarter of a full-time work-year. Thus, the estimated labor-income process includes variation in annual labor income from any unemployment spells that last less than 39 weeks for a full-time worker. This incorporates the vast majority of unemployed workers.[7] The age-specific human capital parameters, $\{\varepsilon_j\}_{j=20}^{100}$ are from Huggett and Parra (2010).[8]

3.4 Government Policy

Government expenditure, $G = 0.106$, is set to ensure it equals 15.7 percent of output. We set the Social Security marginal benefit rates, $\phi_1 = 0.9$, $\phi_2 = 0.32$ and $\phi_3 = 0.15$, to match the piecewise-linear benefit function used in the U.S. Social Security system. To determine the benefit function's knot points, $b_1 = 0.12$, $b_2 = 0.72$ and $b_3 = 1.36$, we set the ratio of the knot point to average labor earnings in the model equal to the corresponding ratio of the actual knot point and the average labor earnings in the data.[9] We choose the social security tax, $\tau^s = 0.096$, so that the social security budget balances each period. With each carbon tax policy we simulate, we adjust the Social Security benefits so that the purchasing power is unchanged from the pre-carbon-tax baseline steady state (Goulder et al. 2019).

In our subsequent computational experiments, we consider two different pre-carbon tax baseline scenarios: one in which the labor and capital tax parameters are chosen to match

[6] We discretize the shocks using two states to represent the transitory and permanent shocks and five states for the persistent shock. To discretize the persistent shock, we use the Rouwenhorst method which is well-suited for discretizing highly persistent shocks with a small number of states (Kopecky and Suen 2010).

[7] The average U.S. long-term unemployment rate (duration greater than 27 weeks) equals 1 percent, and accounts for less that one quarter of total unemployment. Data are from the BLS, we take the average over the five most recent years, July 2014-July 2019.

[8] The values are displayed in Table 3 of Huggett and Parra (2010). Following Peterman and Sommer (2019), we extend and smooth the age-specific human capital values to 65 years using a quadratic polynomial.

[9] The maximum taxable labor income for Social Security corresponds to the top bend point: $y^{h,max} = 1.36$.

the current U.S. labor and capital tax rates and another in which the labor and capital tax rates are set to maximize expected welfare without a carbon tax. To match the current tax rates, we follow Guner et al. (2014) and set the curvature parameter of the labor-tax function, λ_2, equal to 0.031. The parameter determining the level of the labor tax, λ_1, is set equal to 0.827 to clear the government budget constraint. These parameters imply that an agent with the mean labor income faces an average labor-tax rate of 17.4 percent and a marginal labor-tax rate of 20.0 percent. Following Kaplan (2012), the tax rate on capital income, τ^k, is set to 36 percent.

To focus exclusively on the welfare consequences of alternative approaches for recycling the resulting carbon-tax revenue back to agents, we set the tax on carbon emissions at a fixed level of $40 dollars per ton of CO_2 – the initial value proposed by the Climate Leadership Council (CLC, 2019). We also explore the sensitivity of the results across different carbon tax levels. To calibrate the size of the tax in the model, we calculate the empirical value of the tax as a fraction of the price of a fossil energy composite of coal, oil, and natural gas. We calculate the price of this energy composite averaging over the price of each type of energy in each year, and weighting by the relative consumption in each year. Similarly, we calculate the carbon emitted from the energy composite by averaging over the carbon intensity of each type of energy in each year, and weighting by the relative consumption in each year. This process implies that a $40 per ton carbon tax equals 48 percent of our composite fossil energy price in the baseline steady state, yielding $\tau^c = 0.26$.

4 Computational Experiments

We use the model to study the long-run welfare effects of policies that combine the carbon tax with one or more recycling approaches to return the revenue back to agents.

4.1 Recycling Options

We allow the policymaker to return the carbon-tax revenue through direct payments and by altering existing federal labor and capital tax rates. Since we are focused on ways to return the carbon-tax revenue, not raise additional revenue, we do not allow the policymaker to increase income taxes for any individual agent. Additionally, following the macro-public finance literature, we do not permit age-dependent taxes and transfers. Therefore, the optimal recycling approach we identify should be viewed as a constrained optimal approach. Based on these criteria, we analyze combinations of the following five recycling instruments:

(i) a uniform reduction in the capital income tax, (ii) a uniform reduction in the labor income tax, (iii) lump-sum payments that are uniform across agents, (iv) an increase in the progressivity of the labor income tax, (v) income-dependent payments that vary with an agent's total income.

The income-dependent payments are designed to capture the spirit of several policy proposals which suggest using an income-tested approach to return the carbon tax revenue. We model the income-dependent payments, T^c_{ij}, as a liner function of an agent's total income, y_{ij}, according to the equation:

$$T^c_{ij} = \max\left[\Upsilon_1 + \Upsilon_2 y_{ij},\ 0\right]. \tag{8}$$

Again, we bound the rebate function below by zero to avoid raising taxes on any agent.

The increase in the progressivity of the labor tax is designed to mimic a change in the tax code in which the government reduces the average labor-income tax rate for the lower-income agents but does not change the average labor-income tax rate for higher-income agents. While increasing the curvature parameter, λ_2, in the labor-tax function (equation (7)) lowers the average labor tax rate for low-income agents, it increases the average labor tax-rate for high-income agents. This change would not constitute a pure rebate because the tax rate increases for a fraction of the population. Therefore, we augment equation (7) to ensure the average tax rate does not increase for any level of labor income. Specifically, the labor tax rate for an individual with taxable labor income, $\tilde{y}^h_{i,j,t}$, is:

$$\max\left[\min\left[1-\lambda_1\left(\frac{\tilde{y}^h_{i,j,t}}{\bar{\tilde{y}}^h_t}\right)^{-\lambda_2'},\ 1-\lambda_1'\left(\frac{\tilde{y}^h_{i,j,t}}{\bar{\tilde{y}}^h_t}\right)^{-\lambda_2}\right], 0\right],$$

where parameters λ_1 and λ_2 are the baseline values of the level and curvature parameters and λ_1' and λ_2' are the corresponding values in the counterfactual simulation.[10]

4.2 Welfare and Distributional Metrics

We impose a social welfare function to compare social welfare under alternative policies. Following the standard of the macro literature, we measure welfare behind the veil of ignorance. That is, we identify the carbon tax rebate that maximizes the expected welfare of a

[10] To calculate labor taxes in each counterfactual simulation, we keep the value of average taxable labor income, $\bar{\tilde{y}}^h$ fixed at its value in the baseline.

newborn in the future steady state prior to the realization of any idiosyncratic shocks.

We quantify the change in social welfare caused by a carbon tax policy using the consumption equivalent variation (CEV). Again, this welfare measure is ex-ante in that it depends on the agent's expected lifetime consumption before information about the agent is revealed. Specifically, the CEV measures the uniform percentage change in an agent's expected non-energy consumption that is required to make her indifferent – prior to observing her idiosyncratic ability, productivity, and mortality shocks – between the baseline steady state and the steady state under the carbon tax. Formally, we define the CEV as the value of Ω that solves the equality below:

$$\mathbb{E}\left\{\sum_{k=1}^{J}\beta^{k-j}\prod_{q=j}^{k-1}\psi_q\left(\frac{[((1+\Omega)\dot{c}_{i,j,t})^{\gamma}(\dot{e}^{c}_{i,j,t}-\bar{e})^{1-\gamma}]^{1-\theta_1}}{1-\theta_1}-\chi\frac{\dot{h}_{i,j,t}^{1+\frac{1}{\theta_2}}}{1+\frac{1}{\theta_2}}\right)\right\} \tag{9}$$

$$=\mathbb{E}\left\{\sum_{k=1}^{J}\beta^{k-j}\prod_{q=j}^{k-1}\psi_q\left(\frac{[\hat{c}^{\gamma}_{i,j,t}(\hat{e}^{c}_{i,j,t}-\bar{e})^{1-\gamma}]^{1-\theta_1}}{1-\theta_1}-\chi\frac{\hat{h}_{i,j,t}^{1+\frac{1}{\theta_2}}}{1+\frac{1}{\theta_2}}\right)\right\},$$

where the 'dots' denote values in the baseline economy without a carbon tax and 'hats' denote values in the counterfactual economy with the carbon tax in place. The expectation is taken over the lifetime draws of the labor-productivity shock. Note, when $\Omega = 0$, the left-hand-side of equation (9) equals the ex-ante expected lifetime welfare for an agent born into the baseline steady state and the right-hand-side of equation (9) equals the ex-ante expected lifetime welfare for an agent born into the counterfactual economy with the carbon tax.

Since our welfare measure is the CEV between two steady states, it captures the long-run welfare consequences of the carbon tax policy. It does not capture the near-term welfare effects of the policy as the economy transitions to the new steady state with the carbon tax in place. Therefore, our primary results provide insights surrounding the optimal way to rebate carbon tax revenue in the long run, they do not illustrate how to transition to the optimal rebate. We examine the the transitional welfare impacts of the optimal long-run rebate later in the paper.

To quantify the distributional impacts of alternative revenue-recycling mechanisms, we follow Fried et al. (2018) and compute the Gini coefficient for lifetime welfare under the carbon tax combined with each rebate. We define the Gini coefficient, $\mathcal{G}$, as:

$$\mathcal{G} = \frac{\sum_{i=1}^{N} \sum_{j=1}^{N} |x_i - x_j|}{2N^2 \bar{x}}, \tag{10}$$

where x_i represents lifetime welfare of agent i, $\bar{x}$ is the mean of lifetime welfare, and N is the total number of agents in the economy. The Gini coefficient ranges between zero (perfect equality) and one (perfect inequality). It is of course important to stress that the cross-sectional heterogeneity in our model arises from differences in agents' productivity and lifetime earnings. Therefore, while the Gini coefficient effectively captures the distribution of the resulting welfare effects across different income groups, it abstracts from the horizontal distributional effects within income groups that would arise due to other dimensions of heterogeneity, such as geography or occupation, that are not included in our analysis.

5 Quantitative Results

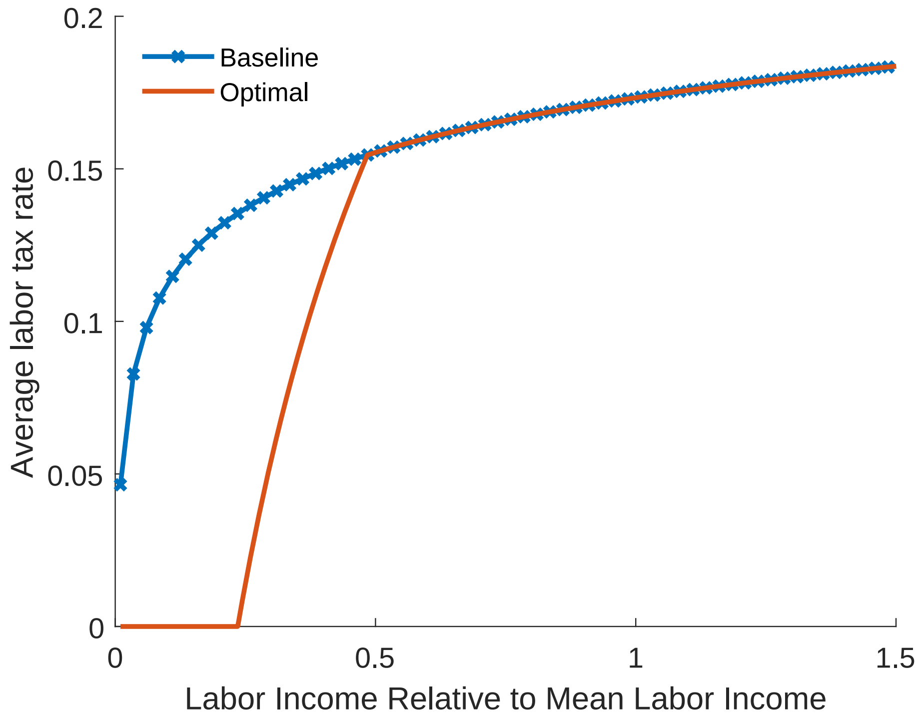
To find the welfare-maximizing recycling approach, we calculate the steady state with a carbon tax over the set of the different combinations of recycling policies. The policies include all combinations of the capital tax, τ^k, the level and progressivity of the labor tax, determined by λ_1 and λ_2, and the slope, Υ_2, and intercept, Υ_1, of the rebate-payment function that clear the government budget constraint and do not increase the capital or labor tax above the baseline levels.

5.1 Optimal Recycling Policy

Starting from a baseline representing our current labor and capital taxes, we find the welfare-maximizing policy uses 64 percent of the revenue generated by a carbon tax to reduce the capital tax by 5 percentage points to 31 percent. The remaining 36 percent of the carbon tax revenue is used to increase equality, specifically by lowering the labor tax for agents earning low labor income. Figure 1 highlights that, under the optimal recycling approach, agents with labor-income earnings below 48 percent of the mean see their average labor tax rates fall, with agents earning below 24 percent of the mean paying zero labor taxes.

The first row of Table 1 reports the welfare and equity impacts of the optimal rebate relative to the baseline, as well as the effect of the rebate on output, capital, and energy use (emissions). We find that the optimal approach for recycling the revenue eliminates almost all of the ex-ante non-environmental welfare loss from the carbon tax, with the CEV

Figure 1: Rebate From the Increase in Labor Tax Progressivity Under the Optimal Policy



Note: The figure displays the average labor income tax rate paid by an agent under the optimal rebate and in the baseline steady state. The average tax rate is displayed as a function of an agent's labor income relative to the mean level of labor income.

falling by only 0.11 percentage points.[11] To understand how the optimal rebate achieves the highest expected welfare, it is important to note that a recycling approach can boost expected welfare by (1) increasing economic efficiency through reductions in pre-existing distortionary taxes and (2) by increasing equity through redistributing resources away from agents with high levels of income, and low marginal utilities of consumption, to agents with lower income, and higher marginal utilities of consumption. The optimal policy combines the most effective efficiency instrument with the most effective equity instrument to achieve both of these objectives.

[11]Recall, these welfare changes do not incorporate benefits stemming from improved environmental quality. However, Table 1 highlights that the change in energy use, and thus the environmental benefits, are stable across the policies. Therefore, abstracting from the environmental benefits will not impact the relative ranking of the policy options.

Table 1: Distribution and Welfare Effects

	CEV	Percent change in			
		Welfare Gini	Output	Capital	Energy
Optimal	-0.11	-2.4	-0.5	-0.5	-31.2
Capital tax	-0.27	-0.0	0.5	1.8	-30.3
Labor tax	-0.54	0.1	-0.5	-1.8	-31.4
Lump sum	-0.64	-1.1	-1.2	-3.4	-32.0
Labor progressivity	-0.13	-3.7	-1.7	-3.8	-32.4
Income dependent					
Welfare max	-0.64	-1.1	-1.2	-3.4	-32.0
Equity max	-1.57	-2.8	-2.6	-7.7	-33.5

Note: Column (1) reports the CEV under the optimal rebate and under each of the simple rebate instruments. Columns (2)-(5) report the percent change from the baseline (no-policy) steady state in the welfare Gini, output, capital, and energy under each of the rebate instruments.

We focus first on comparing the two recycling options that are intended to increase efficiency by uniformly reducing a distortionary tax. The second and third rows of Table 1 report outcomes from using the carbon tax revenue to solely reduce the capital tax (row 2) or the average labor income tax (row 3). Comparing these rows reveals that reducing the capital income tax – as the optimal policy does – achieves greater expected welfare than uniformly reducing the labor income tax. However, the second and third rows of Table 1 also reveal that, in isolation, uniformly reducing the capital or labor income tax would have neutral distributional impacts, with the Gini coefficients of lifetime welfare effectively remaining unchanged. Therefore, to increase welfare through the second channel – i.e. redistributing resources towards agents with lower lifetime welfare and higher marginal utility – at least a portion of the carbon tax revenue will need to be recycled in a progressive way.

Turing next to the equity instruments, our analysis includes several different recycling options that can achieve a progressive redistribution of the carbon tax revenue. One option is to provide lump-sum payments. While these payments do not vary across agents, they will nonetheless provide a relatively larger increase in utility for lower lifetime income agents. Consequently, row 4 of Table 1 highlights that exclusively returning the carbon tax revenue through lump-sum payments reduces the Gini coefficient of lifetime welfare. However, far more redistribution can be achieved by targeting the revenue back to lower income agents. In particular, we consider two ways to do so. First, the policymaker can increase the progressivity of the labor income tax, implying that the carbon tax revenue received by agents varies with their labor income. Second, the policymaker can provide income-dependent rebates that vary inversely with an agent's total income.

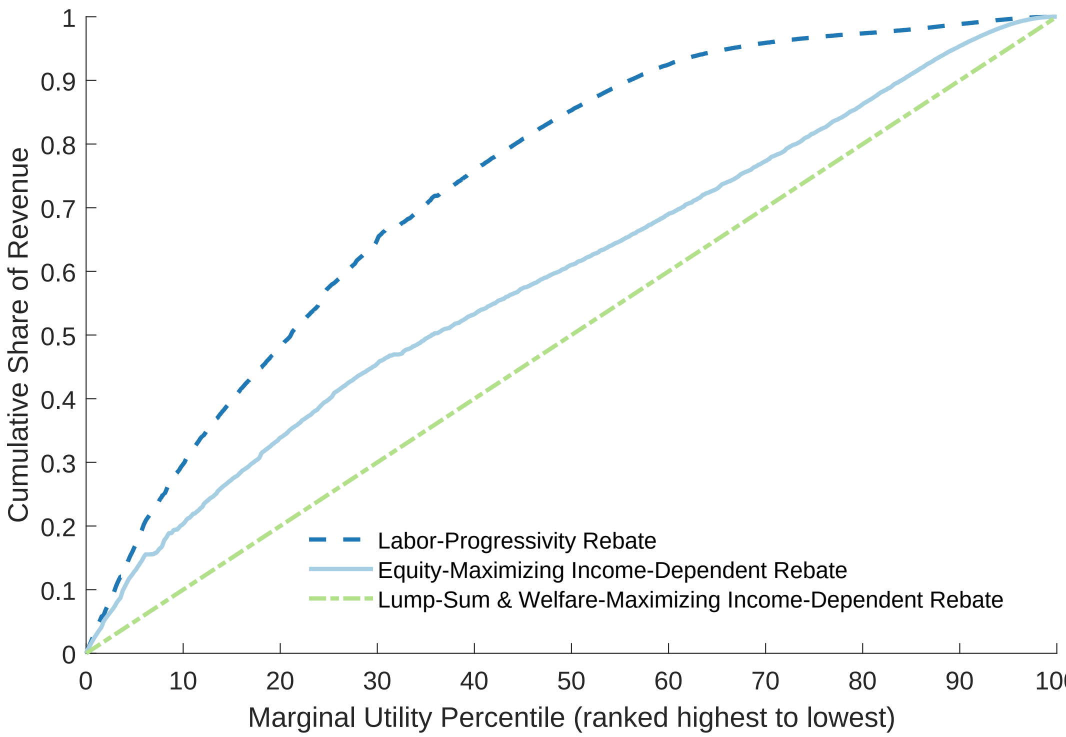
Unlike the other rebate instruments, the change in the progressivty of the labor income tax and the income-dependent rebates are not uniquely pinned down by the amount of revenue generated by the carbon tax. Instead, using either instrument, a continuum of possible outcomes can be achieved by varying two parameters.[12] Row 5 of Table 1 displays the outcome under one possible approach for recycling the revenue through an increase in the progressivity of the labor tax – specifically the labor-tax progressivity change that maximizes welfare. To compare the welfare and equity impacts from the labor-progressivity and lump-sum rebates with what could be achieved by providing income-dependent rebates, we consider two different income-dependent rebate approaches – the one that maximizes welfare (row 6 of Table 1) and the one that maximizes equity (row 7 of Table 1).

Comparing the income-dependent and lump-sum rebate outcomes reveals that the equity-maximizing income-dependent rebate (row 7) achieves a larger increase in equity than the uniform lump-sum rebate (row 4). However, this larger increase in equity comes with a higher welfare cost. The income-dependent rebate that achieves the highest welfare (row 6) is the one that does not vary the rebates with income at all – i.e. it is identical to the lump-sum rebate. The intuition for this result stems from the interaction between the income-dependent rebate and an agent's incentives to save for retirement. Agents receive the income-dependent rebate in every period of their life, including retirement. However, agents with higher incomes in retirement receive a smaller rebate, reducing their incentives to save for retirement. This decrease in retirement savings reduces the aggregate capital stock, raising the welfare cost of the income-dependent rebate. The crowd-out of capital is minimized when the income-dependent rebate does not vary with income.

Comparing the impacts of providing lump-sum or income-dependent rebates to the impact of increasing the progressivity of the labor tax highlights the superiority of returning the revenue through an increase the labor tax progressivity. Across the three simple equity instruments, returning the carbon tax revenue through an increase in the labor-tax progressivity – as the optimal policy does – achieves the highest welfare, the CEV equals -0.13, and the largest increase in equality, the Gini coefficient falls by 3.7 percent.

[12]To recycle a given amount of revenue through a change in the progressivity of the labor tax, there is a continuum of potential combinations of λ_1 and λ_2 from equation (7). Similarly, to recycle the revenue through rebates that are allowed to vary linearly with total income, there are a continuum of possible combinations of the slope (Υ_2) and intercept (Υ_1) from equation (8).

Figure 2: Cumulative Share of Revenue Returned by Marginal Utility



Note: The figure displays the cumulative share of the revenue recycled as a function of the agent's marginal utility under the three progressive recycling approaches. The agents are ranked from highest to lowest marginal utility.

To understand why increasing the progressivity of the labor income tax is better at redistributing than the other progressive recycling options, it is helpful to consider what an ideal recycling approach would do to achieve an increase in equity. The ideal progressive policy would return the revenue back to agents with the highest marginal utility. To examine how well the simple rebates target the highest marginal utility agents, Figure 2 plots a Lorenz-like curve in terms of marginal utility and the cumulative share of rebate received for each of the simple progressive rebate instruments. Specifically, the horizontal axis ranks agents based on their marginal utility in the baseline steady state, prior to the adoption of the carbon tax. Agents with the highest marginal utility are to the left on the horizontal axis and agents with the lowest marginal utility are to the right. The vertical axis displays the cumulative share of revenue that is recycled to individuals with marginal utility greater than or equal the value on the horizontal axis. Among the three progressive recycling options, increasing the labor tax progressivity is the most effective at targeting the revenue back to agents with the highest marginal utility. By increasing the progressivity of the labor tax, approximately 85 percent of the revenue is recycled back to the 50 percent of agents with the highest marginal utility. In contrast, by returning the revenue through the equity-maximizing income-dependent rebates – which vary with agents' total income, not labor income – approximately 60 percent of the revenue is returned to agents in the top half of the marginal utility distribution.

Table 2: Relationship between Payments and Marginal Utility

	Lump sum	Income dependent	Labor progressivity
Correlation with marginal utility	0	0.25	0.57
Within working agents	0	0.63	0.59
Within retired agents	0	0.70	·
Percent of revenue to retired agents	18	64	0

Note: The first three rows report the correlation between marginal utility and the size of the rebate among working agents, retired agents, and the full population for the simple lump-sum, equity-maximizing income-dependent and labor-progressivity rebates. The last row reports the percent of the revenue that is returned to retired agents under each rebate.

To highlight why it is important to target the revenue back to agents with low labor income as opposed to low total income, Table 2 displays the correlation between an agent's marginal utility in the baseline steady state and the amount of revenue they receive under the three progressive recycling options: providing lump-sum payments, providing the equity-maximizing income-dependent rebates, and increasing the progressivity of the labor tax. Regardless of the population we focus on, i.e. the full population (row 1), within the working agents (row 2), or within the retired agents (row 3), this correlation is zero for the lump-sum rebate (first column) because the rebate is the same size for all agents. For working-aged agents, the correlation is larger under the equity-maximizing income-dependent rebate than under the labor-progressivity rebate. However, this relationship is reversed when we expand our focus to the full population. The correlation between the labor-progressivity rebate and marginal utility in the full population equals 0.57, compared to a correlation of only 0.25 for the income-dependent rebate.

The differences in the correlations between marginal utility and the labor-progressivity and income-dependent rebates hinge on the dynamics over the lifecycle. When agents retire, their total income falls but their marginal utility does not dramatically increase because they start to consume their savings. Indexing the rebate to total income forces the policymaker to give a large share of the revenue to retirees with low income who also have relatively low marginal utility. Moreover, rebates to these low-income, low-marginal-utility retirees come at the expense of rebates to working-age agents that have slightly higher income, but also higher marginal utility. Indexing the rebate to labor income instead of total income avoids these difficulties and allows the policymaker to better target high-marginal utility agents across the population.

We conduct an additional set of experiments to highlight that it is important to target revenue back to agents that are both working age and have low income. We first search for a 'restricted' optimal recycling policy in which the policymaker cannot change the progressivity of the labor tax, and consequently, cannot target revenue back to working-age agents. However, we still allow the policymaker to increase equality by providing targeted payments which can vary with an agent's total income (equation (8)). In this setting, we find that it is optimal to exclusively return revenue through a reduction in the capital tax; none is used for equality-increasing payments.

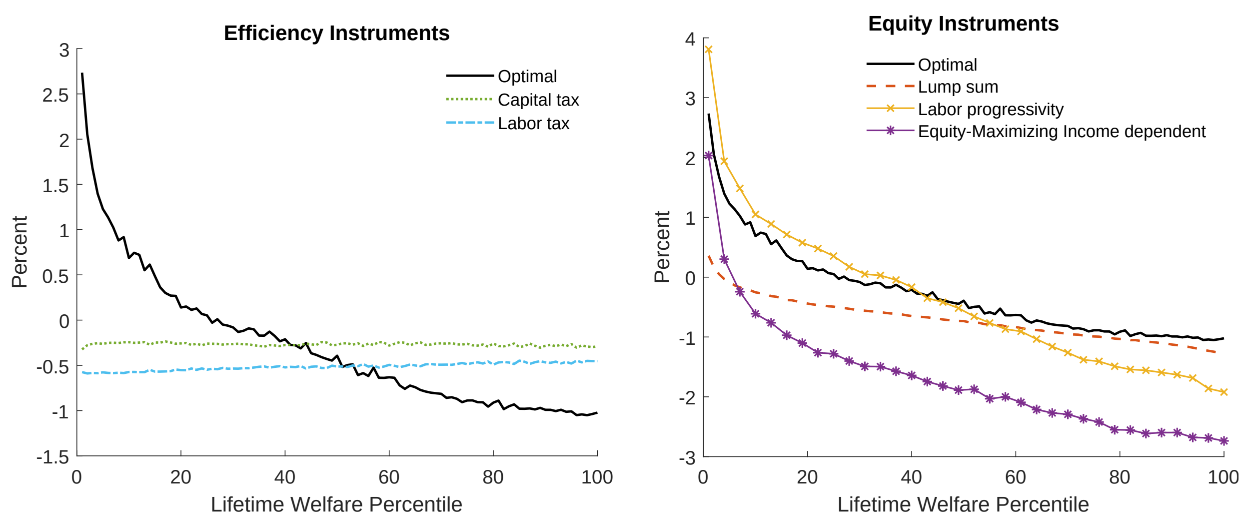
Second, we consider the case in which the policymaker cannot condition the payments on income but they can target working-age agents. We search for a new restricted optimal recycling policy in which the policymaker's only option to increase equity is to provide uniform lump-sum payments to working-age agents only. Again, the optimal approach in this case recycles all revenue through a reduction in the capital tax.

It is only when we allow the policymaker to (i) target rebate payments to working-age agents, and (ii) vary the rebate payment with the agent's total income that we find it is optimal to combine reductions in the capital tax with equity-increasing, targeted payments. In a setting in which explicit age-dependent rebates are not an option, the ability to increase the progressivity of the labor tax provides policymakers with a simple way in which to target carbon-tax revenues towards low-income, working-age individuals.

5.2 Ex-Post Distributional Impacts of Recycling Approaches

The optimal recycling approach identified in the previous section maximizes the expected welfare of an agent born into the future steady state. Ex-post lifetime welfare outcomes will of course differ across agents based on their realizations of labor-productivity shocks. To highlight how the ex-post distributional welfare impacts differ across policies, we examine how each policy affects agents across the entire distribution of ex-post lifetime welfare. To do so, we calculate the percentage change in each agent's baseline consumption that would be required to make her indifferent – after observing her idiosyncratic ability, productivity, and mortality shocks – between the baseline steady state and the steady state under each carbon-tax policy. In contrast to the CEV, which measures the expected ex-ante change in lifetime welfare, this exercise measures the realized ex-post change in lifetime welfare for an agent with a given lifetime sequence of labor-productivity shocks.

Figure 3: Heterogeneity in Ex-Post Welfare Changes



Note: The vertical axis represents the percentage change in baseline lifetime consumption required to make an agent indifferent between living in the baseline steady state and the steady state under a given climate policy. Agents are separated by their ex-post lifetime welfare in the baseline steady state, with the 1st percentile representing the agent with the lowest lifetime welfare.

Figure 3 displays how the ex-post welfare impacts vary across agents based on their realized lifetime welfare in the baseline steady state, with the 1st percentile representing average impact on agents with the lowest ex-post lifetime welfare in the baseline. The left panel displays the ex-post welfare impacts under the optimal policy versus the two simple efficiency rebates and the right panel displays the ex-post welfare impacts under the optimal policy versus the three simple equity rebates. Positive values on the y-axis imply that an agent is better off under the policy outcome than in the baseline, while negative values imply the reverse.

The slopes of the lines in Figure 3 reveal the degree of progressivity of each policy. Recycling the revenue through lump-sum payments, income-dependent payments, or an increase in the progressivity of the labor tax all result in progressive changes to the tax system; the corresponding lines in the right panel of Figure 3 are downward sloping, implying that agents with the highest lifetime welfare in the baseline experience the largest percentage declines is ex-post welfare under each policy. In contrast, the capital and labor tax rebates in the left panel of Figure 3 have relatively neutral distributional impacts; the corresponding lines in the left panel are approximately flat, implying that all agents experience roughly the same percentage decrease in ex-post welfare. At first glance, the finding that the capital tax reduction has a neutral distributional impact is somewhat counterintutive. Given that agents with higher lifetime welfare receive a somewhat larger share of their lifetime income from capital, a reduction in the capital tax would seem to provide relatively larger benefits to the high lifetime welfare agents. However, through the general equilibrium channels, lower lifetime income and welfare agents also benefit. For example, the resulting increase in the after-tax return to capital reduces the costs of holding precautionary savings.

Table 3: Share of Agents Better Off

	Capital tax	Labor tax	Lump sum	Labor progressivity	Income dependent	Optimal
% better off	1.9	0.0	3.1	32.6	5.5	29.4
% prefer optimal	40.4	50.7	83.8	60.1	100.0	-

Note: The first row reports the fraction of households who are better off under the carbon tax with the rebate specified in the particular column then they are in the baseline. The second row reports the fraction of households who are better off under the carbon tax with the rebate specified by the particular column in then they are with under the carbon tax with the optimal rebate. The income-dependent rebate refers to the equity-maximizing income-dependent rebate.

Comparing the optimal policy to the simple capital and labor tax rebates in the left panel of Figure 3 reveals that not all agents prefer the optimal policy ex-post. There is a clear trade off that occurs when a portion of the revenue is diverted away from reducing the capital tax and is instead used to increase the progressivity of the labor tax. Agents with baseline welfare above the 40th percentile experience larger welfare losses under the optimal policy compared to the capital tax reduction. This result is also highlighted in bottom row of Table 3 which displays the share of agents that prefer the optimal policy to each individual recycling approach. In contrast, agents with lower levels of lifetime welfare fare better under the optimal rebate. Notably, agents in the bottom 30 percent of the lifetime welfare distribution experience welfare gains under the optimal recycling approach (top row of Table 3). Ultimately, the sizable ex-post welfare gains experienced by agents with the lowest lifetime welfare cause the optimal policy to achieve higher expected lifetime welfare than using the revenue to exclusively reduce the capital or labor taxes.

Comparing the ex-post welfare impacts of the optimal policy to the simple equity instruments in the right panel of Figure 3 we again see that all agents do not uniformly prefer the optimal policy. In particular, the lowest welfare agents would prefer the increase in labor-tax progressivity to the optimal because they do not experience large benefits from the capital tax rebate. Moreover, the increase in labor progressivity dominates the (equity-maximizing) income-dependent payments for all agents, and dominates the lump-sum rebate for all agents with lifetime welfare below the 60th percentile. Thus, the superiority of the labor-progressivity rebate relative to the other equity instruments would hold for any social welfare function that is not explicitly regressive.

5.3 Does it matter that the revenue is from a carbon tax?

To explore whether there is something unique about a carbon tax that drives the optimal rebate approach identified in the preceding results, we conduct an additional experiment. Instead of imposing a carbon tax, we assume that the government receives an exogenous stream of revenue that exactly equals the amount that would be raised by the carbon tax under the welfare maximizing rebate policy. Starting again from a pre-carbon-tax baseline reflecting our current, sub-optimal mix of income taxes, we search for the optimal way to recycle this new exogenous stream of revenue back to agents.

We find the optimal rebate uses the same two instruments to recycle the revenue. Quantitatively, however, the optimal rebate approach is notably different. While we previously found the optimal rebate uses 64 percent of the revenue from a carbon tax to reduce the capital tax, it is optimal to use only 37 percent of the exogenous revenue stream to reduce the capital tax. This result highlights that the way a new stream of revenue is generated can alter the primary mechanism through which the revenue should be rebated.

The quantitative differences between the optimal rebates of carbon tax revenue and the exogenous revenue stem from the fact that the carbon tax itself depresses capital.[13] Intuitively, the carbon tax reduces energy use, which, all else constant, decreases the marginal product of capital, leading to lower aggregate savings. This effect amplifies the relative importance of reducing the distortions caused by the capital tax. Hence, when the revenue comes from a carbon tax, it is optimal to mitigate the resulting decrease in capital by using substantially more of the revenue to reduce the capital tax.

[13] If the revenue from the carbon tax is not recycled, and instead, say, thrown into the ocean, we find that capital is reduced by 2.62 percent from its value in the baseline steady state.

5.4 Welfare Effects Over the Transition

Our results thus far focus on outcomes for agents born into the long-run steady state with the policy already in place. Yet policymakers and their constituents are not born into the long-run steady state but instead are alive when the policy is introduced. The welfare impacts for these cohorts can differ from the steady state welfare impacts because aggregate capital takes time to adjust to the new policy and because the currently living cohorts only experience the policy for part of their lifetimes. To understand these differences, we analyze the welfare impacts of the optimal policy over the transition.

To calculate the transitional welfare impacts from the optimal policy, we solve for a separate CEV for each age cohort during the transition. The cohort-specific CEV equals the uniform percentage change in the cohort's lifetime non-energy consumption that would be required to make them indifferent, in expectation, between living exclusively in the baseline steady state or living through the transition following the adoption of the carbon-tax policy.[14]

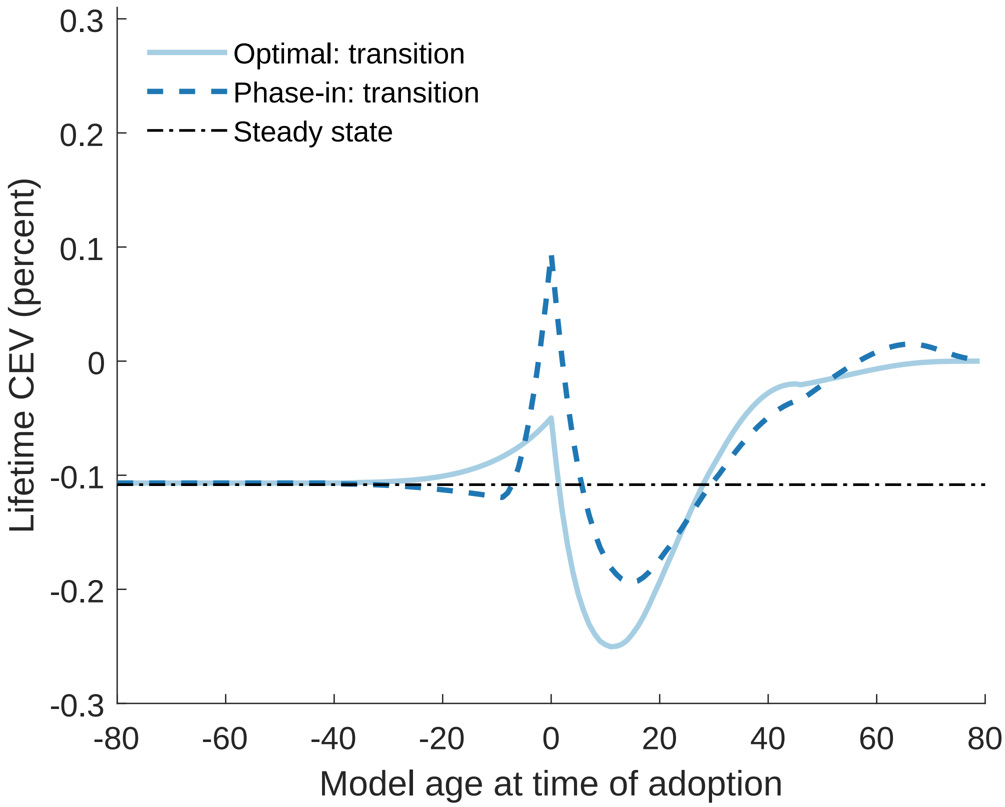
Figure 4 displays the cohort-specific transition CEVs under the optimal rebate (solid light blue line). A cohort with a negative model age at the time of adoption corresponds to a cohort that will enter the model after the adoption of the carbon tax policy. In contrast, a cohort with a positive model age at the time of adoption has already entered the model when the policy is adopted.[15] For reference, the black horizontal line plots the CEV for agents born into the long-run steady state (reported in Table 1). Overall, the welfare impacts for cohorts who live through the transition are largely similar to those who live in the long-run steady state. Focusing on the living agents who have entered the model when the policy is adopted, the population-weighted average CEV under the optimal long-run policy is -0.12, nearly identical to the long-run steady state CEV of -0.11.

Figure 4 does however highlight variation in the CEVs across the living cohorts. To understand what drives this variation in the cohort-specific welfare impacts, it is important to consider how the policy impacts the after-tax returns to capital and labor. Following the adoption of the carbon tax, the pre-tax returns to capital and labor fall. Combined with the uniform reduction in the capital tax under the optimal policy, the after-tax return to capital

[14]Like in the steady state, we calculate the transitional CEV from behind the veil of ignorance, before households know anything about their individual shocks or if/when the carbon tax will be implemented. There is no aggregate uncertainty once the carbon tax is adopted; households know how the path of aggregate wages, interest rates, and taxes over the transition.

[15]The cohort with a model age of negative one begins working one year after the policy is adopted. The cohort with a model age of 0 when the policy is adopted represents 20-year-old agents that enter the workforce at the time the policy is adopted. Agents with a model of age of 46 are those that just retired at the time the policy is adopted.

Figure 4: Welfare Effects Over the Transition



Note: The solid line plots the transitional CEV for each cohort on the x-axis under the optimal policy and the dashed-blue line plots the transitional CEV for each cohort under the phase-in policy. The dashed-dotted black line denotes the CEV for agents born into the long-run steady state.

increases, benefiting all cohorts regardless of their age at the time the policy is adopted. In contrast, because the optimal policy only reduces the labor income tax for low labor-income earners, the changes in the after-tax returns to labor are not uniform across agents. While the after-tax return to labor increases for the lowest labor-income earners, it falls for agents earning higher levels of labor income.

Ultimately, where the cohorts are in their lifecycle when the policy is adopted determines how they are affected by these non-uniform changes in the after-tax returns to labor. Given that agents have lower average labor incomes early in their working lives, the benefits stemming from the increase in the after-tax return to labor for low-labor-income earners accrue primarily to the youngest cohorts. In contrast, for cohorts that have been in the workforce for multiple years, and thus have higher average labor incomes, the costs stemming from the reduction in the after-tax return to labor for most of these agents within the cohort outweigh the benefits from the higher return to savings. Consequently, as Figure 4 highlights, the welfare losses from the policy are relatively larger for cohorts that have been in the workforce for several years when the policy is adopted, and thus don't experience the period when the increase in the progressivty of the labor tax would provide sizable benefits.[16] Finally, cohorts nearing retirement, and those already retired when the policy is adopted, are largely unaffected by decreases in the after-tax returns to labor. Consequently, these older cohorts fare relatively better than the middle-aged, working cohorts.[17]

Given the heterogeneity of the welfare impacts the optimal policy has among the living cohorts, a clear question is can policymakers mitigate the somewhat larger losses experienced by agents in the middle of their working lifetime versus other living cohorts by temporarily altering the policy over the transition? One strategy would be to initially use a portion of the new carbon tax revenue to provide age-dependent transfers targeted towards the cohorts experiencing relatively larger losses. Continuing to assume age-dependent taxes or transfers are not an option, we instead explore an alternative policy that simply combines the optimal long-run policy with a uniform, lump-sum rebate that is phased out after 10 years. Specifically, in the first period of the policy, we set the labor-tax progressivity parameter equal its value under the optimal rebate, but we keep the capital-tax rate fixed at its original level and instead return the revenue through equal lump-sum payments. Over the next 10 periods, we gradually replace the lump-sum rebate with the capital-tax rebate. The dashed blue line in Figure 4 plots the transitional CEV for the phased-in policy. The phased-in policy does begin to mitigate the welfare costs for agents who are in the middle of their working lives when the policy is introduced (e.g., the trough of the U is closer to zero under the phased-in policy than under the optimal). The intuition is simply that agents in the beginning to middle of their working lifetimes benefit more from the lump-sum rebate initially than from the capital-tax rebate because they have not accumulated much capital,

[16]Figure 4 also highlights that cohorts that have just entered the model when the policy is adopted experience smaller losses than cohorts born into the steady state. This is driven by the fact that it takes several years for the pre-tax return to labor to completely fall to the long-run steady state level. Consequently, the youngest working cohorts not only benefit from the increase in the progressivity of labor tax, they also don't experience the full negative general equilibrium effects for their full working lifetime.

[17]Recall, the cohort-specific CEV measures displayed in Figure 4 reflect the uniform percentage change in the cohort's lifetime non-energy consumption that would be required to make them indifferent, in expectation, between living in the baseline steady state or living through the transition. Because the older cohorts experience the costly policy for fewer years, this lifetime CEV measure mechanically moves towards zero as the cohort's age approaches a model age of 80. Importantly, the qualitative patterns displayed in Figure 4 are unchanged by instead calculating the CEV as the uniform percentage change in the cohort's non-energy consumption over their remaining lifetime.

and by the time they reach an age where they have accumulated capital the lower capital tax is phased in.

In sum, the results displayed in Figure 4 highlight that the optimal long-run policy's ability to eliminate almost all of the welfare losses in the steady state does not come at the expense of larger welfare losses for agents living through the transition. Instead, the transitional welfare consequences are largely similar to the steady state impacts. The superiority of the optimal policy in the long-run, as well as the similarity of the policy's long-run and transitional impacts, highlight the benefits of using carbon tax revenue to (1) begin to unwind the distortions caused by the existing capital income tax and (2) increase equity by increasing the progressivity of the labor income tax.

5.5 Sensitivity

Table 4: Sensitivity

	Fraction of revenue used to reduce the capital tax	Percent change in the welfare Gini
Subsistence energy: $\bar{e}$		
$\bar{e} = 0$	0.65	-2.36
$\bar{e} = 0.0013$	0.64	-2.35
$\bar{e} = 0.0026$	0.62	-2.33
Carbon tax: τ^c		
\$30/ton CO_2	0.60	-2.21
\$40/ton CO_2	0.64	-2.35
\$50/ton CO_2	0.66	-2.38

Note: Column 1 displays the fraction of the carbon tax revenue used to reduce the capital tax for different values of subsistence energy, $\bar{e}$, and the carbon tax, τ^c. The remaining revenue is used to increase the progressivity of the labor tax. Column 2 displays the corresponding percent change in the Gini coefficient on lifetime welfare from its value in the baseline. The middle values of $\bar{e}$ and τ^c equal the values from the benchmark calibration.

To explore the sensitivity of the results, we examine how the optimal rebate differs as we vary the level and regressivity of the carbon tax. To vary the regressivity of the carbon tax, we consider different values of subsistence energy, $\bar{e}$. Table 4 highlights that, across the different carbon tax levels we consider, and for different levels of inherent regressivity, it remains optimal to use 60 to 66 percent of the revenue to reduce the capital tax while the remaining revenue is used to increase the progressivity of the labor tax. Regardless of the specification, the carbon tax paired with this combined rebate reduces the Gini coefficient on lifetime welfare from its value in the baseline, raising equality.

While the optimal rebate is stable across the alternative specifications, Table 4 reveals small quantitative differences that illustrate how the level and regressivity of the carbon tax affect the relative importance of using the revenue to unwind existing distortions versus increase equality. When the carbon tax is more regressive (i.e. $\bar{e}$ is larger), the relative importance of using the revenue to increase equality increases. In contrast, as the level of carbon tax grows, the relative importance of using the revenue to reduce the distortions caused by the capital tax grows.

We also explore whether the optimal rebate approach is sensitive to the baseline composition of income taxes. Rather than starting from a baseline matching current U.S. income taxes, we start from a baseline using the optimal mix of income taxes. To identify the optimal pre-carbon tax mix of income taxes, we choose the capital tax and the level and progressivity of the labor tax to maximize expected welfare prior to the adoption of a carbon tax, subject to the same government revenue requirement. In the optimal pre-carbon-tax baseline, the capital tax falls from 36 percent to 11.6 percent while the labor tax becomes slightly more progressive with λ_1 falling to 0.793 and λ_2 increasing to 0.121.

Starting from this optimal pre-carbon-tax baseline, we again find that it is optimal to rebate the revenue by both reducing the capital tax rate and by increasing the progressivity of the labor-tax. While the optimal rebate mechanisms are unchanged, the share of carbon tax revenue going towards each mechanism does differ. Because the capital tax rate is far lower in the optimal pre-carbon-tax baseline, the importance of decreasing the distortions caused by the capital tax is reduced relative to the importance of increasing equality. Consequently, when starting from the optimal baseline, the share of carbon tax revenue used to reduce the capital tax falls from 64 percent to 40 percent.

6 Conclusion

The mechanism through which carbon tax revenue is recycled back to households is an important piece of any revenue-neutral carbon tax policy. This paper solves for the welfare maximizing way to return carbon tax revenue in a general equilibrium lifecycle model of the U.S. economy. In contrast to the early recommendations from the double-dividend literature calling for carbon tax revenues to be returned exclusively through reductions in pre-existing distortionary taxes, we find that it is optimal to use a sizable portion of the revenue to increase equality.

Importantly, the welfare maximizing way to achieve a more progressive outcome is not through the use of lump-sum rebates – the approach garnering the greatest support among many involved in the policy-making process. Instead, we find that a more progressive distributional outcome can be achieved with far lower welfare costs by rebating carbon-tax revenues by increasing the progressivity of the labor tax. We find that when policymakers are not permitted to return carbon tax revenue through an increase in the progressivity of the labor tax, it is no longer optimal to use any revenue to increase equality.

The optimal combination of revenue recycling mechanisms – a reduction in the capital tax coupled with an increase in the progressivity of the labor tax – is robust as we alter the assumed regressivity and level of a carbon tax. Moreover, we find that the welfare impacts on agents living through the transition are similar to the welfare impacts for agents born into the future steady state. Consequently, the optimal recycling approach we identify does not require large welfare losses for current generations in order to maximize welfare for future generations.

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Online Appendix

A Definition of an equilibrium

Let $z_{i,j,t} = (j, a_{i,j,t}, \nu_{i,j,t}, \xi_i)$ denote the vector of household state variables and let Z denote the corresponding state space. We define a sequence-of-markets equilibrium for this economy as a sequence of prices, $\{w_t, r_t, p_t^e\}_{t=0}^{\infty}$, allocations for each household i age j, $\{c_{i,j,t}, e^c_{i,j,t}, a_{i,j,t+1}, h_{i,j,t}\}_{t=0}^{\infty}$, allocations for firms, $\{E_t^y, K_t^y, N_t^y, K_t^e, N_t^e\}_{t=0}^{\infty}$, a Social Security tax, $\{\tau_t^s\}_{t=0}^{\infty}$, a carbon tax, τ^c, transfers, $\{T_t^a, T_t^c\}_{t=0}^{\infty}$, and the distribution of individuals over the state space, Φ_t, such that the following holds:

1. Given prices, household allocations maximize:

$$\frac{\tilde{c}_{i,j,t}^{1-\theta_1}}{1-\theta_1} - \chi \frac{h_{i,j,t}^{1+\frac{1}{\theta_2}}}{1+\frac{1}{\theta_2}} + \mathbb{E}\left\{ \sum_{k=j+1}^{J} \beta^{k-j} \prod_{q=j}^{k-1} \psi_q \left(\frac{\tilde{c}_{i,j,t}^{1-\theta_1}}{1-\theta_1} - \chi \frac{h_{i,j,t}^{1+\frac{1}{\theta_2}}}{1+\frac{1}{\theta_2}} \right) \right\},$$

   subject to the budget constraint:

$$\begin{aligned} c_{i,j,t} + (p_t^e + \tau_t^c) e^c_{i,j,t} + a_{i,j,t+1} = \mu_{i,j,t} h_{i,j,t} w_t - T^s_{i,j,t} + (1 + r_t(1-\tau^k))(a_{i,j,t} + T_t^a) \\ - T_t^h\big(\mu_{i,j,t} h_{i,j,t} w_t - 0.5 T^s_{i,j,t}\big) + T_t^c \quad \text{for } j < j^r \end{aligned}$$

$$c_{i,j,t} + (p_t^e + \tau_t^c) e^c_{i,j,t} + a_{i,j,t+1} = b^{ss}(x_{i,j,t}) + (1 + r(1-\tau^k))(a_{i,j,t} + T_t^a) + T_t^c \text{ for } j \geq j^r$$

   the evolution of labor productivity (equations (2) and (3)) and the non-negativity constraints, $c_t \geq 0$, $a_t \geq 0$, $h_t \geq 0$, and $e_t^c \geq 0$.

2. Given prices, final-good producer allocations solve the profit maximization problem for the representative final good firm:

$$\max_{K_t^y, N_t^y, E_t^y} A_t^y (K_t^y)^{\alpha_y} (N_t^y)^{1-\alpha_y-\zeta} (E_t^y)^{\zeta} - w_t N_t^y - (r_t + \delta) K_t^y - (p_t^e + \tau^c) E_t^y$$

3. Given prices, energy producer allocations solve the profit maximization problem for the representative energy firm:

$$\max_{K_t^e, N_t^e} p_t^e A_t^e (K_t^e)^{\alpha_e} (N_t^e)^{1-\alpha_e} - w_t N_t^e - (r_t + \delta) K_t^e.$$

4. The markets for capital, labor, and energy clear:

$$(1+n)(K_t^y + K_t^e) = \int a_{i,j,t}\, d\Phi_t$$
$$N_t^y + N_t^e = \int \mu_{i,j,t} h_{i,j,t}\, d\Phi_t$$
$$E_t = E_t^y + \int e_{i,j,t}^c\, d\Phi_t.$$

5. The government budget balances:

$$G_t = \int \left[\tau^k r_t(a_{i,j,t} + T_t^a) + T_t^h\left(\mu_{i,j,t} h_{i,j,t} w_t - 0.5\tau^s \min(y_{i,j,t}^h, y^{h,max})\right) + \tau_t^c e_{i,j,t}^c\right]\, d\Phi_t + \tau_t^c E_t^y - T_t^c.$$

6. Transfers from accidental bequests satisfy:

$$(1+n)T_{t+1}^a = \int (1-\psi_j) a_{i,j,t+1}\, d\Phi_t.$$

7. The Social Security budget clears:

$$\tau^s = \frac{\int T^s(x_{i,j,t})\Phi_{Z|j\geq j^r}}{\int [\min(y_{ijt}^h,\ y^{h,max})\partial\Phi_{Z|j<j^r}]}.$$

A *stationary competitive equilibrium* consists of prices, $\{w, r, p^e\}$, allocations for firms, $\{E^y, K^y, N^y, K^e, N^e\}$, a social security tax, τ^s, a carbon tax, τ^c, and transfers, $\{T^a, T^c\}$, that are constant over time and satisfy the conditions 2-7. Allocations for households, $\{c_{i,j,t}, e_{i,j,t}^c, a_{i,j,t+1}, h_{i,j,t}\}$, satisfy condition 1. The distribution of individuals over the state space, Φ, is stationary.

B Calibration

We use a five year average from 2013-2017 for all parameter values and targets that we calculate directly from the data. Data on investment, output, and capital are from NIPA Tables 1.1, 1.1.5, and 1.5. We define investment as the sum of investment in private fixed assets and consumer durables and we define capital as the sum of private fixed assets and consumer durables. Data on government budget outlays comes from the CBO.[18] Since our

[18] See https://www.cbo.gov/about/products/budget-economic-data.

model includes Social Security separate from government spending, we calculate government spending as the difference between total government outlays and Social Security outlays. Data on the carbon intensity, energy prices, and energy consumption are from the EIA.

Using data from the Consumer Expenditures Survey (CEX) spanning 2013 through 2017, we find that the share of expenditures going towards energy is 33.84 percent lower in households in the top half of the total expenditure distribution compared to the bottom half of the total expenditure distribution. However, rather than setting $\bar{e}$ to directly match this difference in the energy expenditure shares, we first must account for the fact that the variance in total expenditures in the CEX is larger than in our model.[19] In particular, the percent difference in total expenditures between the top and bottom half of the expenditure distribution is 288.8 percent in the CEX and 66.7 percent in our model. Following Fried et al. (2018), we deflate the energy expenditure share difference observed in the CEX by $\frac{66.7}{288.8} = 0.231$. To target an energy expenditure share difference between the top and bottom halves of the expenditure distribution of 7.81 percent, we choose $\bar{e} = 0.0013$.

We choose energy-share parameter γ to target the ratio of energy consumed directly by households relative to total energy consumed in the US economy. We calculate the empirical value of E^c/E from data on total primary energy consumption from the Energy Information Administration (EIA). Total fossil energy consumption, E, equals total primary energy consumption of coal, oil, and natural gas reported in EIA Table 1.1. Total fossil energy consumption by individuals, E^c, equals total primary consumption of coal, oil, natural gas by the residential sector (see EIA Table 2.2).[20] The average empirical value of E^c/E over the most recent five years of data, 2013-2017, equals 0.183.

[19] The key reason for the smaller differential in total expenditures in our model is that the productivity shocks are assumed to be log normal. This distributional assumption, while standard in the literature, results in our model failing to capture the extreme top tail of the income distribution. We normalize the CEX data by the square root of family size in all of the calculations.

[20] The EIA data report residential energy consumption of coal, oil, natural gas and electricity. To convert residential electricity consumption to primary energy consumption of coal, oil, and natural gas, we calculate household electricity use relative to total electricity use (see EIA Table 7.6). We multiply this fraction the total amounts of coal, oil, and natural gas used in the electricity sector (see EIA Table 2.6).

Table A1: Parameter Values

Parameter	**Value**
Persistence: ρ	0.958
Persistent shock variance: σ_κ^2	0.017
i.i.d shock variance: σ_π^2	0.081
Fixed effect variance: σ_ξ^2	0.065
Final Good Capital Share: α_y	0.3
Energy Share: ζ	0.03
Energy Capital Share: α_e	0.597
Depreciation: δ	0.079
Risk Aversion: θ_1	2
Frisch Elasticity: θ_2	0.5
Conditional Discount: β	0.995
Disutility of Labor: χ	73.3
Subsistence Energy: $\bar{e}$	0.0013
Consumption Energy Share: $1-\gamma$	0.0093
Debt Limit: $\underline{a}$	-0.156
Labor Tax Function: λ_1	0.827
Labor Tax Function: λ_2	0.031
Capital Tax Rate: τ^k	0.36
SS Payroll Tax: τ^s	0.096
Government Spending: G	0.106
SS max income: $y^{h,max}$	1.358
SS function bend point: b_1	0.118
SS function bend point: b_2	0.724
SS function bend point: b_3	1.358
SS function marginal benefit: ϕ_1	0.9
SS function marginal benefit: ϕ_2	0.32
SS function marginal benefit: ϕ_3	0.15

Note: This table reports the calibrated parameter values.

C Computational Experiments

In the simulations, the carbon tax raises the price of the energy-good which reduces the relative price of the numeraire. Since Social Security benefits are denominated in terms of the numeraire, the purchasing power of the Social Security benefits falls from its value in the baseline. In practice, the U.S. government adjusts Social Security payments each year to ensure that the purchasing power remains constant. Consistent with this policy, we adjust the Social Security payment in each simulation to ensure that the retiree can buy the same bundle of energy and non-energy goods as she could in the baseline steady state. Specifically, Social Security payments in each simulation equal Social Security payments in the baseline times $\frac{c^e(p^e+\tau^c)}{c^e p^e+c}$ where c^e and c are the baseline values of energy and non-energy consumption, respectively. We adjust the Social Security tax to ensure that the Social Security budget balances.