

## Modern monetary theory and environmental taxation

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*My Cambridge Econometrics colleague, Hector Pollitt, [has written a blog post](#) on modern monetary theory and environmental taxation issue that I thought sharing here, with his permission. Like me, Hector seems to take the view that MMT might say that taxes do not fund government spending, but that this does not mean that tax design is inconsequential. In fact, it means the exact opposite. If tax is not funding government spending it can be better designed to change behaviour, which then becomes one of the fundamental roles it can play in the economy.*

*This is Hector's take on this (with light edits to suit this blogs style):*

The concept of environmental tax reform is not new and is core to environmental economics, but is it compatible with Modern Monetary Theory?

Environmental taxes aim to raise revenues for government, while at the same time discouraging behaviour that damages the environment. Examples include the UK landfill tax and the climate change levy.

Environmental Tax Reform (ETR) is when another tax (e.g. on income or labour) is reduced by a similar amount (as happened when the climate change levy was introduced).

The result is a shift in economic resources rather than an increase or decrease in the overall tax take.

Economists debate whether it is possible to obtain a 'double dividend' from ETR of obtaining both better economic and environmental outcomes, but there is a consensus that higher environmental taxes and lower income/labour taxes will broadly offset each other in terms of economic impacts.

### Background to Modern Monetary Theory (MMT)

MMT (as discussed in the context of our modelling [here](#)) suggests that a government must first spend to later gather tax revenues.

*In a country like the UK that issues its own currency, the central bank can always provide liquidity to the government in the form of newly created reserves and the government should never (non-voluntarily) default on its debts.*

*The result is that MMT is increasingly being recognised as the way that government finances work in the real world, as opposed to a world from textbook economics.*

## **Modern Monetary Theory does not undermine the concept of Environmental Tax Reform**

*A simplistic conclusion would be that MMT undermines the whole concept of ETR and the two ideas are incompatible. Raising environmental taxes in ETR is partly to allow other harmful taxes to be reduced. But MMT says that governments could just reduce these other taxes anyway as it is not necessary to balance budgets.*

*Such thinking misses the constraints placed on production by the real economy, however. A government cannot keep on stimulating the economy through tax reduction indefinitely because at some point it will run out of capacity to produce things.*

## **Limitations of the real economy**

*One way in which the economy can run out of capacity to produce things is due to limitations of the workforce (for example, people can only work a set number of hours). Factories and machinery also have their limits and any attempts to push these limits will lead to price inflation.*

*At this point we get back to a classical economic problem of how to best allocate the available resources, based on a set of decisions that the environmental tax can influence.*

*Merging MMT with ETR leads to slightly different thinking. The environmental tax becomes both a tool to push economic activity to less damaging means of production, but also a tool with which to limit the monetary claims on resources in the real economy.*

*Other taxes on things we don't want to discourage (e.g. labour and employment) can be pushed as low as possible, again without stoking inflation. But to be clear, the larger the environmental tax, the more scope there is for reducing these other taxes.*

## **What does this mean from a policy perspective?**

*ETR still looks like a good policy area to pursue but, unless the national economy is in a boom period (i.e. close to full employment), labour or income taxes could be reduced by more than the value of the sums raised by the environmental tax, at least initially.*

*Yes, the government deficit would increase but the outcome would likely be both higher*

*GDP/employment and a better environmental outcome. In summary, a clear double dividend result.*

*If you are interested in the implications of environmental tax reform or any of the other points raised in this blog, please contact me.*

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