

# Green Policies in a Small Open Economy

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## Abstract

The optimal taxation of labour and natural resources and the optimal provision of public consumption and public abatement are analyzed for a small open economy within the context of a second-best framework with environmental externalities. Natural resources and capital are traded on a competitive global market while labour is immobile internationally. Households choose between consumption of produced goods and leisure. Environmental quality worsens when producers use natural resource inputs, but can be improved by public abatement. After characterising the first-order conditions for optimal policies, we analytically explore the consequences of more environmental concern (i.e. greener preferences) for the public finances, employment, and the domestic capital stock. We find that greener preferences typically result in capital flight. Furthermore, employment declines despite the factor substitution that is induced by a lower tax on labour and a higher tax on natural resources. If the uncompensated wage elasticity of labour supply is positive, private utility declines. Public consumption, in contrast, may rise only if most of the improvement in environmental quality occurs through a lower level rather than a cleaner composition of economic activity. However, if the labour supply curve bends backwards, private utility rises while public consumption falls.