BIAC

Business and Industry Advisory Committee to the OECD

Comité Consultatif Economique et Industriel Auprès de l' OCDE

Consultation with EPOC
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BIAC DISCUSSION PAPER

BIAC is pleased to submit this paper to the consultation with the Environment Policy Committee (EPOC) on environmental taxes. This paper presents an overview of our views on the use of economic instruments for environmental purposes, addressing in particular environmental taxes.

I. Introduction

To achieve and maintain environmental quality within the general framework of sustainable development is a primary concern of business. Sound and rational policy instruments must be developed to tackle environmental pollution in a cost-effective way, taking into account social and economic impacts in a balanced and integrated manner. In the right circumstances, market-based responses to environmental challenges, including voluntary or negotiated agreements, can offer advantages over traditional command-and-control measures, which directly influence business' behaviour by prescribing objectives, standards and technologies. Well-designed instruments aim to positively affect the costs and long-term benefits of business decisions and promote the use of environmentally sound products and processes within the framework of the free market. By enabling industry and consumers to adapt to market signals, such instruments can provide greater flexibility than traditional command-and-control regulation and can offer a more cost-effective course of action.

There is an ongoing debate about the effectiveness and efficiency of certain types of economic instruments, notably environmental taxes, for which a number of issues need to be carefully addressed. Business is concerned that the theory of ‘green’ taxation does not always translate well into practice as ‘green taxes’ have the potential to increase costs without measurable benefits to the environment. Governments need to review their overall approach to economic instruments to improve their transparency and effectiveness and to amend where unintended negative consequences have occurred, or where more cost effective options can be found.

II. Economic instruments for environmental policy

There are a number of different economic instruments for environmental policy, including, but not limited to: Fiscal instruments; tradable emission permits; deposit refund systems; certain types of voluntary or negotiated agreements between government and industry. It is important for policy-makers to comprehensively address the following issues when considering the application of economic instruments:

- In theory, full-cost accounting approaches may assist a firm to identify and possibly internalise environmental costs, but economic instruments must reflect environmental impact realistically. This goal is made difficult by a general lack of agreement and sound economic science on the

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cost of environmental effects, leading to a danger of assigning them arbitrary costs. This results in distortions of competitiveness.

- The determination of responsibility for and costs of environmental impacts draws upon the Polluter Pays Principle, which requires that each actor in the production and consumption process be responsible for the pollution linked to its specific activities. The economic chain consists not only of producers of finished goods, but also includes suppliers of raw materials and other inputs such as energy, air and water; the trade and transport sectors; waste treatment bodies; the authorities and the consumers. All actors must be taken into account when allocating responsibility and financial burdens.

- It should be recognised that the application of an economic or fiscal instrument in a particular context may simply shift the burden on the environment to another country or region or to another sector or phase of the production chain.

- In order to truly modify behaviour of firms and consumers, instruments such as taxes and charges must often be set at high levels. The resulting financial burden could affect the economic viability of firms or sectors, and place inequitable costs on poorer segments of society. Since lower levels of taxes and charges may only make a marginal contribution to environmental objectives, the use of this policy option requires careful analysis in particular applications. Governments should refrain from using economic instruments, such as environmental taxes, as revenue-raising mechanisms. This recognises that to the extent that such instruments are successful at discouraging environmentally undesirable behaviour, their revenue collection will invariably decline. Thus, they are an inherently unreliable revenue source.

III. Principles for the application of economic instruments

Economic instruments for environmental policy must be properly designed to meet environmental challenges while taking into account the functioning of the markets. The implementation of economic instruments must be preceded by a comprehensive cost-benefit analysis, and all other policy alternatives should be carefully evaluated to identify the most cost-effective approach. For environmental economic instruments to be effective and efficient, they must meet a number of important requirements:

- The design of economic instruments must be based on solid and complete data and sound science, taking into account cost-effectiveness, but also, uncertainties, policy linkages and alternatives. They must be compatible with the rules of the market economy and the principles of sustainable development.

- The objective of economic instruments must be clear, simple and defensible, and must be transparent to the actors involved.

- The use of economic instruments must not create or be used to justify market distortions or barriers to trade or competition (internally or internationally).

- Economic instruments should only be applied if real choices are available to the actors involved. They should be incentive-based, promoting business innovation and supporting a process of continuous improvement. They should stimulate market forces and economic growth, promote more efficient use of materials and energy, and consider overall life-cycle effects.

- They must be economically efficient and environmentally effective. The incentives used must be proportionate to the costs borne and the benefits to be achieved.

- All of the different actors in the economic chain need to be taken into account.

- Revenues from instruments such as taxes, charges and levies should either be used to protect the environment or be returned to the sectors involved or to the population as a whole in a fiscally neutral fashion. Such instruments should not be used as revenue-raising mechanisms by governments; the implications of possible shifts in fiscal payments from one sector to the next should be carefully evaluated.

- Economic instruments must be adjustable to changing circumstances and should allow time for adjustment by the actors involved. They should take into account national differences among the various actors involved. When the objective set in advance is achieved, the instrument should no longer be applied.

- Economic instruments must be easy to administer, implement and monitor and be compatible with existing tax systems. Administrative costs must be minimal.

- Economic instruments should be designed in collaboration with enterprises and other stakeholders who will be directly affected and should be applied only after full consultation with them to ensure that their implementation is realistic and achievable.

- Economic instruments should address and encourage improvements in environmental performance and should not unduly discriminate against specific sectors, processes, materials, etc. They should provide the bases for optimal economic solutions to specific environmental objectives.

- Any examination of the use of economic instruments should be accompanied by proposals for the reforming of the existing regulatory framework. Market-based instruments should serve as substitutes for, rather than additions to, government regulations.

IV. Environmental Taxes

In recent years, many governments have shown increasing interest in the use of tax measures to pursue environmental aims. In general, the increased use of fiscal measures such as taxes and levies in the environmental field is accelerating internationally in an uncoordinated way. This has the potential to create distortions to cross-border trade and competition, especially where measures have an uneven impact upon foreign goods and processes. The development of some tax proposals has been rushed and insufficiently thought through, resulting in poor design and legislation.

Industry is concerned that ‘green’ taxes could and have often become, simply, revenue-raising mechanisms for governments, leading to economic and fiscal distortions and overall reduced industrial competitiveness. This can have important social consequences. Levies should have a clearly defined steering function, but should not be used as revenue-raising mechanisms. Moreover, they should not increase the overall tax burden. Therefore, revenue collected must be earmarked and either refunded in total or used for projects that are clearly related to the defined environmental objective. Refund has to be designed in such a way that the objectives of the environmental measure are best achieved. In order to avoid political discussions or arbitrary distributions, an equal refund of the revenue raised to the whole population can in many cases be an equitable and fair solution. If the purpose of a tax is to penalise environmentally detrimental behaviour (by increasing costs), then the revenue value of the tax would eventually be non-sustainable, because as the undesirable behaviour changes, the revenue declines. It is essential that such a decline is not compensated by an arbitrary increase of the levies or by an artificial modification of the objective to be achieved.

The above-mentioned principles for economic instruments therefore need to be taken into account. It is essential that all economic instruments - and in particular, taxes - be evaluated in the light of a rigorous economic appraisal based on sound science, with due consideration of social impacts. A monitoring system should be put in place to allow for an evaluation of the environmental effects of price signals arising from an economic instrument. Such a system should allow for a speedy adaptation or, if warranted, elimination of the measure. More weight should be given to developing simplified positive tax incentives to change behaviour.

In setting environmental – and other – taxes, proper consideration needs to be given to the possible impacts of tax policies in a global context, and competitiveness issues need to be clearly addressed. Therefore, international co-ordination is critical for the development of policy initiatives in this area. Because of the specific challenges to be addressed, it is vital that there is effective communication between government, business and other governments to help share information and explore the soundness of principles underpinning the use of green taxes and their potential impacts.

VI. Conclusion

Industry supports an integrated approach to environmental and economic objectives, in which government sets the general framework within which policy is to be implemented and goals are to be attained. Such a framework should ideally combine regulation with market-based instruments and with mechanisms such as voluntary and negotiated agreements, which have the distinct advantage of helping governments to avoid costly regulatory processes and transaction costs and allow design, implementation and monitoring roles to remain with the private sector. Industry requires a framework that is predictable, practical and does not adversely affect the competitiveness of their products and services.

There are clearly a number of challenges related to the application of economic instruments, many of which can be minimised if the principles listed above are observed and a careful evaluation of the use of such instruments is performed. However, it must be recognised that their appropriateness differs from sector to sector, and depends largely upon the context in which they are being applied. It is therefore vital that all proposals are reviewed on a case-by-case basis in a clear and transparent way. An evaluation of the effectiveness and costs of environmental taxes compared to other instruments would be extremely useful. Non-fiscal initiatives can generate promising results. Business-led, market-based voluntary actions, for example, are a flexible and cost-effective way to achieve environmental objectives and allow for easier and thus more rapid adaptation to changing conditions than legislative measures.

No single policy measure or instrument can be considered as a general panacea for all environmental problems. All policies and measures should be considered and the selected measure or mix of measures should take into account the circumstances of the respective target groups, the effects on international competitiveness as well as economic and environmental effectiveness.