



Business and Industry Advisory Committee to the **OECD**

Comité Consultatif Economique et Industriel Auprès de l' **OCDE**

BIAC Position on the Use of Economic Instruments for Environmental Policy

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I. General debate

In the right circumstances, market-based responses to environmental challenges can offer advantages over traditional command-and-control measures, which directly influence business' behaviour by prescribing objectives, standards and technologies. Well-designed economic instruments including voluntary or negotiated agreements affect the costs and benefits of business decisions and promote the use of environmentally sound products and processes. By enabling industry and consumers to adapt to market signals, they can provide greater flexibility than traditional command-and-control regulation and can offer a more cost-effective course of action.

However, there is an ongoing debate about the effectiveness and efficiency of certain types of economic instruments. This paper presents an overview of industry's (1) current position on the use of economic instruments for environmental purposes.

II. Definition and use of economic instruments:

Generally, economic instruments for environmental policy aim to incorporate environmental concerns into day-to-day business decisions by internalising environmental costs. They are market-based in that they allow business to respond to market signals, and provide the opportunity for industry to continue to innovate, seeking new, competitive solutions to environmental challenges. There are a number of different economic instruments for environmental policy, including, but not limited to:

Fiscal instruments, which use the tax system to influence industry and consumer behaviour. These comprise taxes, charges or levies on products or emissions, and can also include fiscal incentives. The taxes/charges/levies are levied against those deemed to be contributing to the environmental problem in question.

Tradable emission permits: Quotas, allowances or ceilings on pollution emission levels of specific businesses that, once allocated by the appropriate authority, can be traded among businesses. Businesses producing below their emissions ceiling can sell excess permits to those producing more than their allowance.

Deposit refund systems: deposits levied on a product at the point of purchase in order to encourage consumers to return the product or its packaging after use against refund of the deposit.

Certain types of voluntary or negotiated agreements between government and industry, which help reduce both compliance and enforcement costs and provide businesses with the flexibility and motivation to tailor approaches to their specific needs, can also be considered as economic instruments, although such agreements can sometimes resemble traditional regulation in their approach.

Industry supports the use of market-based approaches to environmental policy and believes that, if designed and implemented appropriately, these instruments can provide a means for encouraging more sustainable and environmentally sound economic development. However, it is important for policymakers to recognise the following shortcomings of economic instruments and to address these comprehensively when considering their application:

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 how to cost environmental effects, leading to a danger of assigning them arbitrary costs. This could result 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.

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 trade and competition, especially where measures have an uneven impact upon foreign goods and processes.

It should also 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 location 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. Since lower levels of taxes and charges may make only a marginal contribution to environmental objectives, the use of this policy option requires careful analysis in particular applications.

Economic instruments such as taxes and charges can have significant appeal to many governments, not only as an environmental policy tool, but also because they produce revenues that would not otherwise arise. Indeed, industry is concerned that some taxes, etc., could become, simply, revenue-raising mechanisms for governments, leading to economic and fiscal distortions and overall reduced industrial competitiveness. This can have important social consequences.

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 market. 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, set out below.

1. 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.
2. The objective of economic instruments must be clear, simple and defensible, and must be transparent to the actors involved.
3. The use of economic instruments must not create market distortions or barriers to trade or competition.
4. 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.
5. The incentives used must be proportionate to the costs borne and the benefits to be achieved.
6. All of the different actors in the economic chain need to be taken into account.
7. Instruments such as taxes, charges and levies should either be used to protect the environment or be returned to the sectors involved in a fiscally neutral fashion:
 - they 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 evaluated.
8. 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.
9. Economic instruments must be easy to administer, implement and monitor and be compatible with existing tax systems.
10. Economic instruments should be designed in collaboration with the 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.
11. 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.

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

IV. Subsidies

Subsidies have often been used as economic instruments to induce behaviour conducive to environmental improvement. However, they tend to distort market signals, and their use can be negated or even counterproductive by shifting consumption and production processes to inputs and outputs that may be no better in their overall environmental impact, often resulting in additional public expense. Industry does therefore not consider the use of subsidies as an appropriate approach to environmental policy. Promoting market/consumer awareness of (unsubsidised) alternative products or processes would be preferable.

The OECD has recently undertaken a wide-ranging assessment of the impact of subsidies on the environment, the relation of various subsidies to taxation systems, and the costs and benefits of subsidy removal. Industry views this as an important and positive step toward seeking to correct imbalances, which hinder the smooth functioning of market forces.

V. 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 shift the costs of design, implementation and monitoring back to the private sector.

There are clearly a number of challenges related to the application of market-based 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. In addition, as demonstrated by the example of the carbon tax, the requisite international co-ordination, essential to avoid distortions of trade and competitiveness, will most likely be extremely difficult to achieve. The use of economic instruments is therefore not a universal panacea for environmental problems.

1) This paper reflects the synthesised views of industry as represented by BIAC, the ICC, CEFIC, the EU Committee of the American Chamber of Commerce in Belgium, the WBCSD, the World Energy Council, the European Round Table of Industrialists, and the European Brands Association