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RECOMMENDATIONS TO GOVERNMENTS OF ECE COUNTRIES IN TRANSITION ON THE APPLICATION OF ECONOMIC INSTRUMENTS FOR BETTER INTEGRATING ENVIRONMENTAL POLICY WITH SECTORAL POLICIES

submitted by

the ECE Committee on Environmental Policy
through the Ad Hoc Preparatory Working Group of Senior Officials

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RECOMMENDATIONS TO GOVERNMENTS OF ECE COUNTRIES IN TRANSITION ON THE APPLICATION OF ECONOMIC INSTRUMENTS FOR BETTER INTEGRATING ENVIRONMENTAL POLICY WITH SECTORAL POLICIES[1]

There has been a trend in countries in transition towards a more consistent and extended use of economic instruments in environmental policy since the adoption in 1992 of ECE recommendations on the application of the OECD Guidelines and Considerations for the Use of Economic Instruments in Environmental Policies in these countries. There is growing evidence that economic instruments can effectively protect the environment, if properly designed and implemented. Furthermore, economic instruments can contribute to effectively integrating environmental and economic policies and achieving sustainable development. Therefore, Governments of ECE countries in transition are invited to give consideration to the following recommendations.

Take full advantage of the opportunities offered by the economic transition

1. For economic instruments to be introduced effectively and successfully, property rights, including property rights on natural resources, and liability rules should be firmly established and/or further clarified. In addition, an appropriate institutional capacity should be in place.

[1] Prepared at the ECE/OECD Workshop on the Role of Economic Instruments in Integrating Environmental Policy with Sectoral Policies (Prühonice, Czech Republic, 8-10 October 1997).

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2. To ensure that economic agents have real alternatives when making choices and can better adapt to economic instruments, non-essential public monopolies should be privatized and the economy should be appropriately deregulated while evolving towards free markets.

3. Opportunities provided by the economic and taxation reform process should be fully exploited, in particular:

- Restructuring and removing subsidies detrimental to the environment, e.g. in energy, industry, transport and agriculture. Removing direct or indirect subsidies, such as tax benefits, to consumers of particular types of energy and transport services can lead to substantial changes in choices of such services and hence decrease the pollution load. Such an approach should aim at internalizing environmental costs by taxing products and activities that pollute more than others to alter relative prices. The removal or restructuring of distortionary subsidies should take due account of their economic and distributive objectives and benefits. It may be preferable to replace them by lump-sum transfers to beneficiaries;

- Removing existing distortionary direct or indirect taxes and tax provisions, i.e. those likely to have a negative environmental and/or economic impact. While a number of current taxes, such as energy, vehicle or other transport-related taxes, can have positive environmental effects, others may have adverse environmental implications. Reducing distortionary taxes and adjusting tax systems could, in the medium and long term, bring about not only environmental but also economic benefits: increased economic efficiency thanks to fewer economic distortions and more efficient environmental protection;

- "Greening tax systems" (i.e. integrating environmental concerns into the design of tax systems), according to their specific economic, fiscal, budgetary and environmental context. Comprehensive environmental tax reforms can be revenue-neutral: additional environmental taxes, including taxes on natural resource use, are compensated by a reduction in other taxes so as not to increase the total fiscal burden. If deficit reduction/revenue raising and reducing economic distortions are a priority, environmental taxes may also raise revenue in ways which do the least damage to the economy.

Implementing economic instruments

4. Economic instruments should have clear environmental objectives. In particular, emission taxes or charges should first focus on the most important pollutants. It may be better to control toxic pollutants by bans or other forms of direct control.

5. Emission taxes or charges should be linked, as closely as possible, to externalities, that is the damage caused by the polluting emissions. If the emissions of a complex mix of different substances are taxed, a compromise should be found between sophisticated formulas and oversimplified ones.

The tax or charge base should be made as simple and explicit as possible. The rate of the tax should be sufficiently high so as to achieve environmental goals, although this may not be necessary in all circumstances.

6. When introducing environmental taxes and charges, countries with low initial marginal pollution abatement costs, will be able to achieve abatement objectives with relatively low taxes or charge rates. These rates could be progressively raised, according to a pre-announced schedule.

7. New eco-taxes or charges can be applied to products which create pollution when they are manufactured, consumed or disposed of, for instance, taxes on lubricants, fertilizers, pesticides, non-returnable containers, batteries, feedstock chemicals.

8. Opportunities for using the revenue of taxes and charges should be carefully studied: reduce distortionary taxes, reduce public deficits, increase public spending, and/or earmark for specific environmental purposes. While earmarking revenue from environmental user charges (e.g. waste and water charges) will continue to play an important role, earmarking the revenue from environmental taxes should be considered with caution. There is a clear risk that such policies contribute to an inefficient allocation of resources; it may also cause governments' spending priorities to become "locked in", thereby limiting their future options for policy changes. Earmarking environmental taxes should be only a transitory approach.

9. Due consideration should be given to the possible use of tradable permits for addressing regional or global environmental problems, and in particular for controlling greenhouse gas emissions.

10. The acceptance of economic instruments by stakeholders, in particular ministries responsible for sectoral policies, industry and other major groups, should be secured through appropriate consultation and cooperation during the design and implementation stages of the instruments. For instance, "green tax commissions" could be set up to investigate ways and means either of deepening and strengthening current tax reforms or of implementing new ones. These commissions should comprise government officials (e.g. Ministries of Finance, Environment, Agriculture, etc.), independent experts, members of parliament, representatives from different stakeholder groups, including environmental NGOs.

11. In view of their accession to the European Union (EU), applicant countries in transition should further explore the opportunities for introducing economic instruments, in particular to take full advantage of the recent evolution in EU policy.

Economic instruments to foster sectoral policy integration

12. For economic instruments to play a major role in policy integration, their objectives should be clear and explicit. If the environmental objective is hidden in complex policy interactions, support for economic instruments from stakeholders will be weak and the instruments will be difficult to implement. For instance, whether "green" energy taxes are primarily designed to reduce polluting emissions and conserve energy or as a source of general revenue should be made explicit.

13. In the energy sector, existing subsidies should be eliminated or redirected away from fossil fuels to encourage energy saving, energy efficiency and the use of renewable energy sources. Assistance to poorer income groups affected by this subsidy removal should preferably take the form of lump-sum payments. As energy is a major source of pollution and of tax revenue, restructuring energy taxes and prices is one of the most promising paths to a green tax reform. For instance, instead of a flat rate (e.g. per litre), fuel tax could be at least partly based on the content of carbon and other polluting components. Promoting higher taxation of diesel fuel for motor vehicles may restrain the overdevelopment of road transport (in particular freight) and the multiplication of diesel cars, which are a significant source of pollution and noise. An initiative to tax aircraft fuel should be supported at the international level.

14. The full social and environmental costs of transport activities should be assessed and assigned to the user. This necessitates an increase in costs for all modes of transport. In the short run, transport costs will have to be explicitly increased for those modes which least cover their environmental, infrastructure and social costs, in particular goods transport by road and individual car passenger transport. In the medium term, transport costs will have to rise as well. Parking space regulations in cities should include two components; the introduction of taxes on public parking spaces and the reduction of maximum parking time.

15. In agriculture, phasing out support measures such as price support and lower input prices (e.g. on water for irrigation, pesticides, fertilizers and feedstock chemicals) can also reduce adverse environmental impact. In particular, the full application of the polluter-pays principle should be progressively achieved. On the other hand, as agriculture does provide amenities, these should be paid for (i.e. the beneficiary-pays principle).

16. In countries where both unemployment and labour-related taxes and charges are high, reducing these taxes and charges could boost employment. Some payroll tax cuts could be financed by new or higher eco-taxes, thus possibly providing a “double dividend” in terms of both improved environmental protection and lower unemployment. At a time of public finance deficits, environmental taxes can provide revenue to offset, at least in part, the revenue loss caused by lower labour-related taxes and charges.

Policy packages

17. Due to the variety and complexity of environmental problems, economic instruments can be increasingly integrated into broader policy packages, comprising, inter alia, regulations and voluntary schemes. The policy mix should be considered case by case and depend on the prevailing circumstances, the type of environmental issue, the number of stakeholders, etc.

18. To foster the integration of environmental concerns into other policies, the linkages between environmental and other governmental departments (e.g. in the context of “green tax commissions“) should be tightened, thereby ensuring that economic instruments can make the optimal contribution to broader policy objectives.

Monitoring and evaluation

19. The performance of economic instruments should be systematically evaluated. This can be achieved by devising in-built evaluation processes to collect and process relevant data throughout the introduction and operation of the instrument. Such an evaluation should be carried out by independent bodies and the results should help to improve the design and operation of the instrument (feedback loop).

20. The wider economic effects of economic instruments should also be assessed, in particular their effects on inflation and international trade and their distributive effects (for instance, if eco-taxes or charges on mass consumption products could have regressive distributional effects).

International implications

21. When ecotaxes and charges are introduced unilaterally, special provisions may be made for sectors subject to international competition. For instance, a “green” energy tax could be recycled to industry in the form of grants for energy-saving investments, investments in renewable energy sources and assistance to small and medium-size enterprises. In the case of product taxes, “border tax adjustments” could be made to exempt exported products from the tax, but subject imported ones to the domestic tax. Accordingly, domestic and imported goods could be treated equally. This approach conforms with the country-of-destination principle and is consistent with World Trade Organization rules. Exempting export-oriented industries from eco-tax might, however, defeat the environmental objective of the tax. Taking concerted action with other countries would minimize the potential leakage of emissions and undesirable competitiveness effects.

Follow-up

22. The exchange of experience with the application of economic instruments for environmental policy should be further pursued by international organizations, in addition to bilateral cooperation, in particular, through a joint OECD/ECE endeavour to compare, at the pan-European level, national environment-related charges and taxes in the transport and energy sectors. This could be based on case studies prepared by participating countries and take into account relevant activities in other forums, e.g. those building on the “Sofia Initiatives”.

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