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The fiscal system and the polluter pays principle - a case study of Ireland.

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Chapter 1

INTRODUCTION

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This study looks at the scope for applying economic instruments to support environmental policy. Its aim is to establish the realistic potential for application of such instruments, at present and in the near future. This economy-wide scan looks at the major economic sectors (eg transport, tourism, agriculture), to identify areas of environmental concern. The economic instruments in question include charges on pollution (or eco-taxes), user and product charges, administration and monitoring charges, fines, tax differentiation, subsidies, deposit refund systems, et cetera.

International interest in the potential for the use of economic instruments for environmental protection has been growing recently. Examples of such interest are seen in the EU's Fifth Environmental Action Programme *Towards Sustainability* (CEC, 1992), in the Delors White Paper on *Growth, Competitiveness, Employment* (CEC, 1993), and in the conclusions of the European Council at Florence[1] in June (EC, 1996). It was over two decades ago however, when the use of economic instruments was first recommended by a prominent international organisation, in the OECD's classic paper *The Polluter Pays Principle* (1975). The OECD stated that the polluter should be the first party to pay. Rather than seeing pollution charges as a hindrance to trade, they saw them more as the correct basis for avoiding distortions in international trade if countries adopted common cost-allocation rules.

Interest in Ireland has also grown, as exemplified in the recent Budget speech of the Minister for Finance. He stated that he wanted Departments and relevant Agencies to:

[1] "The European Council ... requests the Council to submit to it, before the European Council in Dublin, a report on the development of the tax systems within the Union, taking account of the need to create a tax environment that stimulates enterprise and the creation of jobs and promotes a more efficient environmental policy" (page 3).

> *examine the strategic impact of taxation on environmental policy and to bring forward specific tax measures for the 1997 Budget...* (Stationery Office, 1996)

which is an encouragement to analysts to describe some practicable options, subject to correct economic principles.

There are several reasons for this growth in interest, including the recognition that regulations, the alternative means of protecting the environment, are costly to enforce and do not provide an ongoing incentive to good environmental behaviour. The argument is becoming more convincing that there are external costs which the public bear and for which the polluter does not pay. If the polluter is allowed to continue evading the costs, this effectively sustains polluting behaviour.

The correct economic aim, broadly speaking, is to optimise society's wellbeing. This does not mean giving precedence to the environment over the economy or vice versa, as they should both be valued in the measure of wellbeing. The ideal is to try where possible to indicate the value of the damage, to locate the point at which the harm occurs and face polluters with these costs (or if relevant the prevention or clean-up costs). In theory, costs at the margin should be estimated and should form the basis of the charge. In practice, directions rather than precise figures for charges are likely to emerge from much of the analysis at this stage. If implemented, these reforms should bring improvements to the current situation, at minimum cost to society.

The term *market-based instruments* is also often used. This should not be taken to imply that the environment can be left to the market - indeed the existence of hidden costs (or externalities) is what makes it necessary for governments to interfere. Existing market forces can be exploited to help the environment, by means of market-based instruments which work through getting the prices right.

It is noted that different authorities elsewhere have different objectives in their approach to eco-taxes. Some aim simply to ensure that polluters pay the external costs they impose. From this

comes the reassurance that false signals and incentives are removed. Others try to achieve targets and structure the eco-taxes accordingly. Others again would see eco-taxes as a source of revenue to the public purse. It has been decided in this document to apply the first objective, being the most clearly advisable approach, and that the second should apply where appropriate. This is not to deny that revenue from pollution taxes can be useful and recycled in a fiscally neutral, or indeed beneficial manner. This might include the reduction of labour taxes in Ireland's case, or replacing central government taxes by local charges, or replacing waivers by compensating social welfare receipts.

Ideally, one wishes to present the proposed reforms to society as a mere switch in taxes or subsidies, rather than as a net increase, compared with the present situation or compared with what it might be. Pollution taxes can be more about allocating costs, than about increasing them.

It will not come as a surprise to find that there are several existing economic policies in place which act perversely on the environment. Superimposing countervailing economic instruments, as has been done in the past, may not be sensible in some situations; consequently, the remit of the study has expanded somewhat to include the adjustment of existing policies. Also in the past, there has been a strong tendency to subsidise good environmental behaviour rather than tax the bad, with the result that the subsidies or concessions had to be financed out of other taxes.

The environment is a multi-faceted subject, as its name suggests. There are several ways to compartmentalise a study such as this - by category of environmental medium such as air, water, landscape et cetera, or by economic instrument such as taxes, subsidies and the like, or simply by economic sector. The latter categorisation was chosen as it seems more focused and may facilitate any future integration in analyses involving economic sectoral data.

The report is structured as follows. Chapter 2 describes some background issues to give the context and the constraints, which are relevant to many succeeding chapters. Chapter 3 is an overview of economic instruments that are available, describing some of their theoretical and operational advantages and disadvantages. The succeeding chapters cover the main sectors of the economy: agriculture and forestry; industry's and households' use of environmental services;

energy; transport; tourism and construction. Each sector is covered under the following sub-headings:

1. The environmental impact of the sector, indicating any valuations of the external damage or benefits that have been undertaken.

2. The existing fiscal treatment of the sector in Ireland and ensuing environmental effects.

3. A description of the options for applying economic instruments for environmental protection in this sector, based on information from Ireland and abroad.

4. The resulting suggested use of economic instruments in the sector.

The last chapter summarises the findings and adds some final observations and conclusions.

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