

ECO-TAX in Developing countries: Prerequisites

Developing economies could derive greater benefits from EIs if they were introduced early in the policy development process. In fact, structural adjustment and economic and fiscal reforms should provide a unique opportunity to implement economically efficient resource management instruments. This is all the more necessary as command and control regulations are facing great difficulties in developing countries, particularly due to the lack of appropriate administrative and judicial structures and political will. Corruption is also eroding the enforcement process.

There are many issues and prerequisites to the application of EIs in developing economies. The following is a non-exhaustive list of supportive preconditions for eco-tax.

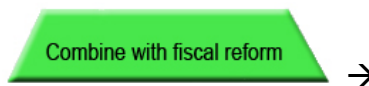


Structural adjustment requires tax reform, including removal of distortionary taxes and introduction of eco-taxes. An uncoordinated proliferation of new eco-taxes should be avoided. Too many taxes could be confusing, difficult to apply and counterproductive (complexity and “tax fatigue”).

An integrated “tax package” should therefore be implemented.

A possible hierarchy of steps might include:

- removing environmentally damaging, distorting and costly subsidies;
- identifying and removing environmentally damaging taxes or exemptions;
- examining how existing taxes may be adapted to address environmental problems;
- developing new eco-taxes.



EIs are not a panacea. Experience in OECD countries shows that they are invariably used in combination with regulations. The complementarity of EIs and regulation should be clearly specified: What specific role are EIs designed to play — a revenue-raising and/or an incentive role?

How are EIs and regulations to be combined and made complementary?

Are EIs designed to evolve over time, and how?



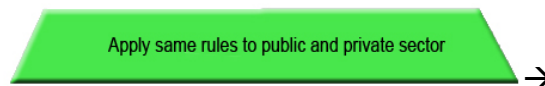
The main purpose of EIs is to provide an incentive function, to induce economic agents to take the most appropriate measures based on their own cost/benefit

assessment. However, this function may be difficult to fulfill in the short term, as high rates of taxes and charges may cause economic and political hardship.

Environmental improvements can be facilitated during a transitional period if the revenue provided by eco-taxes is earmarked to specific and well-defined environmental purposes. Revenue can be used, inter alia, for:

- pollution control equipment;
- cleaning up;
- monitoring and enforcement;
- R & D.

However, care should be taken not to provide artificial life support to obsolete plants. This financing function of taxes and charges should help to keep a stable financial source for environmental protection which could otherwise be jeopardized during the economic restructuring period. Nevertheless, earmarking should be limited to the transitional period and the level of taxes and charges should increase progressively to an incentive level, according to a predetermined schedule.



Many developing economies, especially formerly centrally planned ones, have inherited a large public sector which is being progressively privatised. There should be equal treatment for public and private sector industries. Exemptions and waivers for the public sector would perpetuate distortions and compromise the achievement of environmental objectives.



Levels of taxes and charges based on the high marginal cost of obsolete plants and equipment will force expensive adaptation costs for these plants which may not be viable in the medium term. Part of eco-tax revenue could be allocated to accelerate technical change (e.g., R & D subsidies) or measures to support the transfer of Environmentally Sound Technologies (ESTs).



When structural adjustment policies — in particular removal of distorting prices and subsidies and fiscal reform — are implemented, the introduction of EIs should take place as early as possible in the context of these reforms.

Correcting government failures



In market economies, environmental degradation is essentially caused by so-called “market failures”, i.e., when prices do not adequately reflect environmental values. Similar failures are introduced by inappropriate and poorly targeted government interventions that cause environmental disruption; these are:

Administered prices: when prices are fixed by government, and not the market, for social or economic reasons. This may be the case for low energy prices and low agricultural input prices (pesticides, fertilizers).

Subsidies: Pesticides are heavily subsidised, up to 90 per cent of the price in certain countries. Price distortions such as these should first be removed before any new economic instruments are introduced. This is an essential aspect of a structural adjustment process, necessary for a sustainable development path.

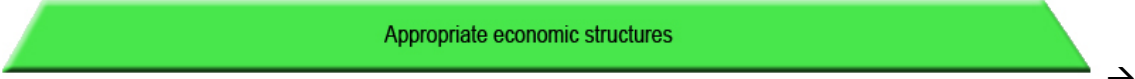
Appropriate institutional structures and administrative skills



Well defined and enforced property rights. Deterioration and wastage of resources is due to the public good nature of environmental resources, considered as “res nullus”. Collective goods cannot be appropriately priced and managed. Property rights, especially on land, must be exclusive, transferable and safe.

- Well defined and stable regulatory framework. In developing economies, uncertainty about future institutions and rules can be a serious obstacle to investment planning and decisions. Well-defined rules of the game are an essential prerequisite to the operation of EIs. Also, during a period of market-oriented policy reform, enterprises may be particularly sensitive to economic incentives as new rules are implemented and new investment decisions are made.
- Appropriate institutions. Fiscal structures and administrative skills must be developed. Initially, best use should be made of existing structures. For instance, as the introduction of new eco-taxes may require new structures and mechanisms, it may be more efficient to introduce environmental incentive into taxes which have to be levied anyway (e.g., taxes on goods and services), while introducing new taxes progressively, as the administrative and technical capacity develops.
- EIs which are simple and transparent. Tax avoidance is facilitated when the sophistication of fiscal systems makes them hard to understand, to accept and to enforce (see also the OECD guidelines). Acceptance and application of the "polluter pays principle".

Appropriate economic structures



In particular, the following are critical:

- functioning markets;
- controlled inflation (inflation erodes the effectiveness of EIs);
- efficient and transparent circulation of information to economic agents
- (information on prices, technologies, environmental conditions and objectives);
- removal of the monopolies, which are widespread in developing economies but especially prevalent in formerly centrally planned economies. Throughout the reform period, many public enterprises will retain a degree of monopoly, thus enabling them to pass on taxes and charges to their customers, rather than taking appropriate environmental protection measures. This could seriously jeopardize the role of EIs.