EFR – differences and similarities between developed and developing countries
A case study of Sri Lanka

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Background and rationale of the Sri Lankan study

The study objectives are:

- To provide an objective analysis of the current application of economic instruments (EIs) in environmental policy in Sri Lanka;
- To assess the role of EIs in generating funds for long-term financially sustainable environmental investments; and
- To make recommendations for policy development / implementation.

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The study should be seen in a wider political context

- Initiating the process of sustainable development; and
- Realising of Millennium Development Goals (MDGs) – poverty reduction and environmental sustainability.

Significant financial resources are necessary to achieve the objectives of sustainable development and also of MDGs → require mobilisation of domestic resources – one of the major challenges countries like Sri Lanka is faced with.

Revenue generating effect of EIs could create additional financial resources → a concept termed as Environmental Fiscal Reform (EFR).

Environmental Fiscal Reform – World Bank and OECD

EFR which *… refers to a range of taxation and pricing measures which can raise fiscal revenues while furthering environmental goals* (OECD, 2005)

Environmental Fiscal Reform (EFR) can play an important role in this regard [achieving the MDGs]*, helping countries raise revenues, while creating incentives that generate environmental benefits and support poverty reduction efforts. EFR has the potential to free-up economic resources and generate revenues that can help finance poverty reduction measures, for example infrastructure that improves access of the poor to water, sanitation and energy services*
(World Bank, 2005)

What is understood under ETR/EFR – the European perspective?

Environmental tax reform (ETR) is basically a reform of the national tax system where there is a shift of the burden of taxes from conventional taxes, such as labour, to environmentally damaging activities, such as resource use or pollution. Revenue neutrality is an important characteristic of ETRs in Europe meaning that overall tax burden remains the same (government budgetary position is unchanged).

Environmental fiscal reform (EFR) is a broader principle, which focuses not only on shifting taxes and tax burdens, but also focuses on reforming subsidies.

(European Environment Agency, 2005)

EFR/ETR - synergies and differences

EFR approach as promoted by OECD / World Bank:

- Achieving *environmental goals* plus *generating revenue* to be used for reaching national policy objectives (funds to be used for environmental investments, social and educational issues, poverty reduction measures) → addressing problems developing countries are facing.

ETR/EFR as implemented in several EU member states:

- Main approach can be summarised as a *tax shifting programme* aiming to reach two goals: environmental and economic/employment goals. *Revenue neutrality* is a decisive component of this approach.

Findings of the Sri Lankan study – main results of the stock take

EIs have been implemented in different economic sectors

- transport and energy sectors are most targeted
- water supply pricing and electricity pricing: inverted block tariff (increasing block tariff – regularly included 'lifeline tariffs')
- EIs are also in use in other sectors (agriculture, fishery, tourism, etc.)

No coherent strategic policy approach

- Subsidies (2004 and 2005 – petroleum products, fertiliser)
- 'Hidden' subsidies – ongoing financial support of state-owned companies (Ceylon Electricity Board 'electricity pricing – average tariff lower than average cost over years → loss', Ceylon Petroleum Company, etc.)

→ financial / budgetary implications: drain of scarce public funds

→ The question is who are the beneficiaries of these policy measures?

Findings of the Sri Lankan study – main results of the stock take

Implementation of instruments fragmented

- No user charges for waste collection and disposal, wastewater user charges in place

Legislative framework is largely in place but enforcement / compliance is relatively poor

- Waste policy (National Strategy for Solid Waste Management) … *a system of user fee should be introduced …*
- Wastewater – National Water Supply and Drainage Board calls for '*Sewerage Service Charge*' and Central Environmental Authority proposes *'Load-Based License Fee Scheme'* (i.e. type of water effluent tax)

Implementation and enforcement lacks effectiveness – EIs seems to be heavily driven by social considerations (environmental benefits and revenue raising potential not fully utilised)

Findings of the Sri Lankan study – the revenue side

Revenues of environmental taxes – the options:

- General budget – *the 'normal/average' case – (6-7% of total tax revenue in OECD / EU and 3-4% of GDP)*,
- Earmarked to finance specific environmental programme (domestic resource mobilisation) → approach used in many economies in transition!

Total environmental revenues are generated from taxes levied on energy products (around 60-70%) followed by taxes levied on transport (20-30%) – findings of many studies!

Situation in Sri Lanka is rather different: ~40% – ~60%

Findings of the Sri Lankan study – the revenue side

Situation in Sri Lanka – state budget implications

Energy and transport taxes versus subsidies (petroleum products and fertiliser)

	2004	2005	2006 estimate	2007 projected
Env tax revenue in % of total tax revenue	8.7 %	10.6 %	9.3 %	8.8 %
Env tax revenue in % of GDP	1.2 %	1.5 %	1.4 %	1.4 %
Subsidies in % of tax revenue	7.8 %	9.5 %	5 % (min)	n.a.
Subsidies in % of GDP	1.1%	1.4 %	0.8 % (min)	n.a.

Outcome of the Sri Lankan study – some proposals

- adjust fuel taxes and reduce disparity between petrol and diesel tax
- revision of electricity tariffs
- restructuring of water pricing regime and introduce user charges for wastewater
- introduce groundwater/surface water extraction and water effluent tax
- introduce user fee for waste collection and disposal
- introduce product taxes (plastic bag) and deposit-refund schemes for plastic bottles
- indexation of tax and charge rates to inflation
- introduction of an Environmental Fund

Outcome of the Sri Lankan study – general remarks

Main findings of Sri Lankan study:

- Economic instruments (environmental taxes) are being applied in Sri Lanka.
- Factors limiting the efficacy of economic instruments in Sri Lanka range from deficiencies with regard to the design of environmental taxes and tariffs to the aspects of the institutional, administrative, regulatory and political framework.
- Political priority given to environmental projects and the environment seems to be rather low - although strategies/policies are established but not transposed.
- Subsidy reform plus revision of pricing structure (electricity / water) is essential.

Political aspects of EFR – summary

- EFR as promoted by OECD and the World Bank can be an appropriate tool to further environmental goals in pursuing the MDGs.
- Political, social, economical and legislative aspects of the individual country have to be reflected when designing an EFR.
- Although the underlying principle of an ETR/EFR is similar in developed and developing countries, their actual design and policy goals planned to be achieved may differ widely.

Finally …
The most recent development in Sri Lanka

- In view of the outcomes of the study on economic instruments, the Ministry Environment and Natural Resources (MENR) reached consensus with the Ministry of Finance & Planning to introduce new environmental tax measures in the 2008 budget!

- Ministry of Finance & Planning asked the MENR to establish new laws for implementing new environmental taxes!