

# Resource productivity, environmental tax reform and sustainable growth in Europe



## Environmental tax reform: qualitative research in the Czech Republic

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# **ENVIRONMENTAL TAX REFORM – QUALITATIVE RESEARCH IN THE CZECH REPUBLIC**

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## **INTRODUCTION**

Using economic instruments of environmental policy has had a long tradition in the Czech Republic. Pollution charges have been gradually introduced since the 1960s. Air emission charges were levied first in 1967. Charges for effluent wastewater into surface waters were instituted in 1979. The current system of economic instruments of the environmental policy in the Czech Republic was introduced in the early 1990s during the process of establishing new state environmental policy and legislation. It consists of air emission charges, sewage charges, water pollution charges, charges on municipal waste, charges on solid waste disposal, water extraction charges, charges for dispossession of agricultural and forest land, and mining charges.

Environmental taxes started to be discussed in the first half of the 1990s within the process of transition to a market economy, when the changes to the entire tax system provided space for introducing new taxes. The act on public finance reform, which entered into force in 1993, provided a concrete scope for ET introduction – a specific paragraph was introduced to the tax act.

First discussions of environmental taxes started in the context of how to use environmental taxation in praxis for environmental protection. The initial idea was that ET and environmental charges could work in parallel, while the ET would focus on the environmental problems not covered by the charges (e.g. taxation of particular products such as paints).

The latter half of the 1990s was characterized by the intellectual shift from ET to ETR. The concept of the ET started to be perceived in a context of labour taxation lowering. This stage of the ETR preparation in the Czech Republic is connected with first calculation studies of potential ETR impacts. In those days, ETR became – with a certain degree of generalization – regarded as a really strong instrument in the environmental field especially among

politicians and experts, namely those from the Ministry of the Environment. From the theoretical point of view, this period of the ETR debate was mostly based on the idea of the Pigouvian taxation and internalization of externalities, but the potential for revenue generation was also discussed.

The concept on the environmental tax reform was first explicitly prepared by the Ministry of the Environment and the Ministry of Finance in the year 2000. The Czech Government discussed the proposal in the first half of 2001. Further work on the ETR was interrupted by Government Decree No. 652 of 25 June 2001.

The new governmental Coalition Agreement signed in June 2002 asserted the ETR as one of the goals and priorities of the new Government. The Government Agreement explicitly included a commitment to “start working on a revenue-neutral ETR in the Czech Republic”. This intension was also traced in the “Proposal of a Public Finance Reform” (PFR) in 2002. After that, however, ETR was not included in the first phase of the PFR in 2003. Despite that, the PFR introduced a significant increase in excise duty rates on motor fuels (e.g., 0.42 - 0.49 Euro/l for petrol, 0.14 Euro/l for diesel oil, and 0.12 Euro/l for LPG) and simultaneously a decrease in income tax from 31% to 24% in 2006.

Another draft of the ETR was prepared in November 2003 and has been updated several times since then. For instance, there was a commitment to prepare a proposal of fiscal-neutral ecological tax changes in accordance with the EU laws in the program statement of the government in August 2004, and a working material of the Ministry of the Environment on ETR (MŽP 2005) was frequently discussed. Impact studies of the ETR implementation impacts have been developed as well (see, for instance, Ščasný et al. 2005, Beneš et al. 2006).

## **CURRENT STATE OF THE ETR INTRODUCTION IN THE CZECH REPUBLIC**

The exemption for the Czech Republic from EC Directive No. 203/96 will expire at the end of 2007. This was the main reason for the necessity to implement it at least at its minimal rates since January 1, 2008.

The final version of the ETR was approved by the Czech Government in May 2007. This version follows the above mentioned EC Directive, current

Czech legislation, a Government Assignment, the official State Environmental Policy of the Czech Republic, and the Official State Energy Policy of the Czech Republic.

According to this version, from 2008 solid fossil fuels will be subject to a rate of 0.3 EUR per GJ of gross calorific value. This will trigger a rise in the price of solid fuels for households by approximately 10%. Natural gas will be taxed at a rate of 1.1 EUR per MWh of gross calorific value. Electricity will be taxed by 1 EUR per MWh, which will cause approximately 1% increase in the household electricity prices. Electricity generated from renewable sources will be exempted from the taxation.

At the end, the Government opted to apply tax exemptions to:

- household heating with natural gas,
- district heating, if the heat is generated from combined heat and power technology,
- power and heat from renewable energy sources, methane and nitrogen fuel cells,
- the Government has retained the zero excise duty tax on the use of compressed natural gas in vehicles,
- electricity used in rail and traffic will not be subject to the excise duty either,
- coal used for production of electricity.

The Government approved a schedule of the future stages of the ETR implementation in the Czech Republic. According to this schedule, the ETR implementation is divided into three phases:

- Phase I consists of the implementation of Directive 2003/96/EC on taxation of energy products and electricity, and will be implemented from 2008;
- Phase II is focused on the transformation of air emission charges into environmental (carbon) taxes and the ETR fiscal neutrality fulfilment. This phase should be prepared by the end of 2008 and realized between 2010 and 2013;
- Phase III should be prepared by the end of 2012 and realized between 2014 and 2017. According to the governmental material, the ETR should be deepened and extended to other natural resources, natural services, etc.

New quantifications of the potential impacts of the ETR in the CR were conducted after the ETR was approved by the Government (see Ščasný & Brůha 2007, Zimmermannová 2007).

## **QUALITATIVE RESEARCH AND ETR**

### **METHODOLOGY OF THE RESEARCH**

The methodology of qualitative research was used for the analysis of practical barriers and obstacles to ETR implementation in the CR. The knowledge of the theoretical background of ETR, findings from the quantitative studies concerning the potential impacts on particular stakeholders, and knowledge gathered from frequent working contacts with people representing various stakeholders were taken into consideration at the beginning of the preparation of the research.

The following research questions were set before the qualitative research started:

- Who are the main stakeholders involved in and influenced by the ETR in the Czech Republic?
- Are environmental taxes, and/or ETR viewed as a suitable instrument for energy efficiency improvement?
- Do various groups of stakeholders have different attitudes to environmental taxes and ETR? What are the main differences?

First, problem focused interviews were realized with two main key experts who have been participating in the ET and ETR discussions and preparation in the Czech Republic since the very beginning. The first one was from a research institute, the other one from the Ministry of the Environment, previously working at the Ministry of Finance department responsible for financing environmental protection from the state budget. A questionnaire was prepared for the focused interviews.

Based on the results of the focused interviews, questionnaires for semi-structured interviews were developed. Representatives of public administration bodies, the industry sector and labour unions were the first subjects included in this stage of the research.

The questionnaires contained the following areas developed into sets of open-ended questions:

- awareness and detailed knowledge of ETR;
- identification of main stakeholders' interests;
- comparison of acceptance of ETR and other environmental policy instruments for particular subjects;
- knowledge of the ETR impacts on the interviewed subject;
- main costs and benefits to particular subjects;
- Perceived positives and negatives of the ETR implementation for the subject;
- ETR influence on the process of innovation and energy saving provisions in the companies;
- What factors could change the subject's attitude to the ETR if it is negative.

A total of 7 interviews was realized: 3 interviews with public administration bodies, 2 interviews with industry sector representatives, 1 interview with a labour union representative and 1 interview with an NGO representative.

## **PRELIMINARY RESULTS OF THE RESEARCH**

Pilot interviews brought following preliminary findings among stakeholders.

### ***Public administration bodies***

Public administration bodies have different attitudes to ETR concept and its implementation in the Czech Republic. Ministry of the Environment (MoE) had no agreement about main goal of the ETR in the Czech Republic. This goal varies from taxation of externalities to improvement of energy efficiency and also to public health protection. By the Ministry of Finance (MoF) point of view, ETR is only fiscal instrument helping to decrease state budget deficit, so the main goal of ETR is by MoF viewed as additional income to the state budget.

They also have exaggerated expectation from ETR. The ETR concept become most popular in the second half of 90s and was very often viewed as powerful and almighty instrument, e.g. ETR was mentioned in proposals of Waste Management Plan of the Czech Republic.

Public Administration bodies agreed, ETR was not supported by any significant PR campaigns explaining positive impacts of ETR process (lower wage cost, decreasing energy dependency, etc.). Also in the process of public hearing only few stakeholders (except public administration) were invited to cooperate.

The idea, that ETR is implemented only for ETR, was mentioned sometimes by public administration representatives, what means, that idea behind ETR was lost during the implementation process and it corresponds to the finding of non consistent opinions to main goal of ETR. Also no ETR versions (taxation of energy products, or energy, etc.) were considered in the process of ETR implementation.

Selected public administration representatives also worried about transformation of existing system of environmental charges to environmental taxes. Environmental charges are revenues of the State Environmental Fund, which will co-finance Structural fund project till 2013 focused on improving quality of the environment.

Phase I of ETR (implementation of the Directive 2003/96/EC on taxation of energy products and electricity) will be joined by higher administrative and transactional cost (about 300 jobs), these personal costs represent about 5% of environmental taxes revenue in the year 2008.

### ***Labour unions***

Labour unions representatives emphasized, there was no relevant discussion with representative stakeholders for the Phase I of ETR in the Czech Republic. Czech political bodies were also criticized for no effort to utilize transitional period of the Directive 2003/96/EC on taxation of energy products and electricity implementation, which was possible to postpone to year 2012. Labour unions are afraid of parallel effects of new energy taxation due to Directive 2003/96/EC and VAT rate increase of heat producing in central heating plants, which both will come into force since 1<sup>st</sup> of January 2008 and will increase living cost for households. They also agreed, that Phase I of ETR will have no significant impacts on industry sector.

### ***Industry representatives***

Industry representatives confirmed, they expected higher tax rates, than the Phase I ETR taxes will set. Fiscal goals and offer to decrease a dependence

on the oil imports are main aims of ETR by their point of view. Industry representatives also expect higher price increase, than are official counted results in quantitative models by MoE.

Representatives of industry sector also agreed on narrow possibilities to transfer energy price increase into output price due to strong international competition. On the other hand, these narrow possibilities cause decrease investment potential of companies to energy savings measures. Finally industry representatives agreed, ETR will have no important potential impacts on energy savings, ETR can motivate just to low-budget energy savings measures, but not to higher investments. ETR concept will be most plausible, if industry representatives will know more about process of ETR revenues recycling.

## **DISCUSSION AND CONCLUSION**

There is a great deal of controversy about the economic consequences of ETR. Proponents of the “double dividend” hypothesis on the one hand argue that the cuts in direct income taxation outweigh the burdens of the increase in indirect taxation, so that the ETR will not only improve the environment, but also increase employment and economic growth. On the other hand, if the cut in the direct taxes is not effective enough (for instance due to enormous administrative costs), then the ETR may have very adverse effects on the economy, including negative impacts on the industrial competitiveness and welfare. If the tax base of the environmental taxes is going to erode, the ETR can cause problems of unstable public finance.

The transaction costs of the “fiscal neutrality” measures are not known yet; there are still few estimations for Phase I of ETR (with no fiscal neutrality requirements) available, as mentioned above. Effects of the cut in the direct taxation have still not been precisely estimated and as known from Germany and UK experience, it is really hard to value effects of the direct tax cut on the economic productivity. The Czech Republic and other CEE countries have (due to their energy intensive economies) truly big potentials for energy savings.

There is one really important question, which is also supported by the preliminary results of our qualitative research in the Czech Republic. It is the question whether to transfer the ET into charges, or whether the charges are to be cancelled and all payments connected with the environment should be realized through ET.

The first stage of the research in the Czech Republic showed several important preliminary results, which should be taken into account in the process of ET and ETR implementation in the Czech Republic and maybe also in other CEE countries. They are as follows:

It seems that during the process of the ETR preparation, the reason for implementation as well as the intended goal of ETR implementation was more or less lost.

The main goal of the ETR was not formulated and especially publicly promoted so far in the Czech Republic, which can partly explain why the interviewed stakeholders' opinions on the ETR importance varied. The goal of the ETR thus could not and in reality was not broadly claimed; public relations in the case of ETR or environmental taxes were insufficient and downgraded.

On the one hand, the first period of Directive 2003/96/EC on taxation of energy products and electricity implementation was not at the most utilized for energy efficiency stimulation. On the other hand, the question arises whether new EU Members should have the same goals concerning environmental quality as the old members, and what should be the degree of their independency in formulating their environmental policy goals. But it might work as a long-term strategy of environmental policy.

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