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# IN BRIEF

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## Ecological Fiscal Reform

### INTRODUCTION

Fiscal policy can be defined as the way in which the government exerts influence on the economy through its taxation and spending decisions. A growing number of observers, ranging from the Green Budget Coalition to the Organisation for Economic Co-operation and Development (OECD), have noted that fiscal policy in Canada is sometimes at odds with the Government of Canada's stated sustainable development objectives. This paper presents some of the arguments that are raised by these groups in support of so-called ecological fiscal reform.

### WHAT IS ECOLOGICAL FISCAL REFORM?

Ecological fiscal reform (EFR) is defined by the National Round Table on the Environment and the Economy (NRTEE) as "a strategy that redirects a government's taxation and expenditure programs to create an integrated set of incentives to support the shift to sustainable development."<sup>(1)</sup> It is important to emphasize that EFR goes beyond the isolated use of fiscal instruments to support particular environmental objectives. Rather, EFR entails a broad reorientation of the fiscal framework to facilitate the long-term transition to sustainable development. The objective of EFR is to ensure that government revenue and expenditure programs and policies send economic signals to producers and consumers that are consistent with sustainability objectives.

Concerns about climate change, air quality, and water quality and availability have made Canadians and their governments increasingly aware of the need to reconcile economic and environmental objectives. While the Government of Canada has embraced sustainable development as an overarching policy objective, the NRTEE notes that "it has employed fiscal policy, its single most powerful instrument to achieve that objective, only to a very limited degree," relying instead largely on a mix of regulatory

measures, voluntary agreements and information campaigns, with mixed results.<sup>(2)</sup>

Amongst the policy tools at a government's disposition, fiscal instruments such as taxes and tradeable emission permits can be the most environmentally effective, particularly in cases where regulations would be difficult to enforce. Furthermore, fiscal instruments are generally the most economically efficient, in part because they are simple, flexible, and provide a continuous incentive to firms and individuals to find innovative and cost-effective ways to reduce pollution.<sup>(3)</sup>

### IS REFORM NECESSARY?

Under the current federal fiscal regime, there are few fiscal mechanisms in place to help ensure that the costs of pollution are borne directly by those firms or individuals who caused it. Thus, there are scant fiscal incentives not to pollute. The result is that the land, the atmosphere and bodies of water are freely used as receptacles for pollution, resulting in more pollution than would have otherwise been produced had its full cost been borne by its producer. The costs, sometimes referred to as negative externalities, are borne by society as a whole.

Economic theory suggests that the costs of pollution can be "internalized," or factored into the price of goods produced and consumed, through the use of economic disincentives such as taxes. In this way, individuals and firms receive the proper price signal and adjust their behaviour accordingly. Sending the economic signal that pollution is costly is one of the primary objectives of EFR.

In a recent study, the OECD concluded that all orders of government in Canada should expand their use of economic instruments in support of sustainable development objectives. The OECD noted in particular that governments should strive to apply the

“polluter pays” principle more rigorously and continue to phase out environmentally harmful direct and indirect subsidies.<sup>(4)</sup>

Similarly, Canada’s Commissioner of the Environment and Sustainable Development, in her 2004 report, exhorted the Department of Finance to do more to identify those areas where the federal tax system may be acting as an impediment to the attainment of sustainable development. The Commissioner further called on the department to review ways in which the tax system could be used to better integrate the economy and the environment.<sup>(5)</sup>

### **ECOLOGICAL FISCAL REFORM: EARLY EXPERIENCES IN CANADA AND ABROAD**

All levels of government in Canada have already introduced a variety of fiscal measures to protect the environment and, in some cases, to promote sustainable development. Some, such as deposit-refund schemes for beverage containers and municipal waste disposal charges, have a long-standing and relatively successful history. More innovative initiatives, such as Ontario’s cap and trade system for emissions of nitrogen oxides and sulphur dioxide from power plants, are also being introduced.<sup>(6)</sup>

The Government of Canada is also making use of fiscal instruments, including tax measures, in support of sustainable development objectives. Federal tax measures include accelerated capital cost allowance for renewable energy generation equipment, a reduced inclusion rate on capital gains for donations of ecologically sensitive land, and an excise tax exemption for ethanol fuel.<sup>(7)</sup> Federal subsidies, meanwhile, are being used to support wind power plants and other renewable power production.

Fiscal instruments are being used in Canada to protect the environment and to promote more sustainable economic activity, particularly in the energy sector, albeit in a limited and piecemeal way. These instruments, however, coexist with tax and other fiscal measures that support environmentally harmful or otherwise unsustainable activities. The OECD notes that “there has been a positive trend with respect to reduction of environmentally harmful direct subsidies in several sectors (e.g. agriculture, fisheries, coal) but not in others (e.g. mining and some fossil fuel sectors).”<sup>(8)</sup> Echoing the OECD, the NRTEE and other groups have encouraged the Government of Canada to embrace EFR and ensure that fiscal instruments are deployed in an integrated and coherent fashion in support of domestic sustainable development objectives.

A number of European countries, such as Denmark, Norway and Sweden, have undertaken substantial ecological fiscal reforms. These countries have, in particular, made considerable progress in better aligning their tax policies with environmental objectives. The impetus behind these reforms is the view that taxes ought to apply primarily to what society wants less of, namely pollution. At least eight European countries have introduced taxes on carbon emissions and on releases of pollutants; in some cases, payroll taxes such as employers’ social security contributions and taxes on income have at the same time been reduced in an effort to maintain a constant tax burden and secure the support of the public for the reforms. It has been suggested that ecological tax reforms that shift taxes from employment to pollution in a revenue-neutral way can give rise to a “double dividend” from more effective environmental protection and higher employment.<sup>(9)</sup>

- (1) National Round Table on the Environment and the Economy, *Toward a Canadian Agenda for Ecological Fiscal Reform: First Steps*, Ottawa, 2002.
- (2) National Round Table on the Environment and the Economy, “Ecological Fiscal Reform (EFR) and Energy,” [http://www.nrtee-trnee.ca/eng/programs/Current\\_Programs/EFR-Energy/EcologicalFiscalReform\\_e.htm](http://www.nrtee-trnee.ca/eng/programs/Current_Programs/EFR-Energy/EcologicalFiscalReform_e.htm); see also National Round Table on the Environment and the Economy, *Economic Instruments for Long-term Reductions in Energy-based Carbon Emissions*, Ottawa, 2005.
- (3) Organisation for Economic Co-operation and Development, *Sustainable Development: Critical Issues*, Paris, 2001.
- (4) Organisation for Economic Co-operation and Development, *OECD Environmental Performance Reviews: Canada*, Paris, 2004.
- (5) Office of the Auditor General of Canada, *2004 Report of the Commissioner of the Environment and Sustainable Development*, Chapter 3, “Sustainable Development Strategies: Using the Tax System and Managing Office Solid Waste,” Ottawa, 2004.
- (6) The sulphur dioxide trading scheme in the United States is widely lauded as a very successful trading mechanism that has helped in the cost-effective reduction of emissions that contribute to acid rain.
- (7) Similar tax exemptions on ethanol and other alternative fuels apply in most provinces.
- (8) Organisation for Economic Co-operation and Development (2004).
- (9) Organisation for Economic Co-operation and Development (2001).