

CTM/G8351/JHU

Geneva, 25 January 2008

## IRU POSITION ON THE INTERNALISATION OF EXTERNAL COSTS

*Achieving Sustainable Development by applying the Cheapest Cost Avoider Principle instead of the Polluter Pays Principle*

IRU Position on a modern economic theory for the internalisation of external costs.

### I. ANALYSIS

The liberalisation of economies and the globalisation of markets has created a new economic framework based on the free movement of people, goods and services. Due to its high quality door-to-door service road transport has become an integral part of any logistic system and thus a vital production tool.

It is true that road transport like every human activity has a negative effect (externalities) on the environment. However, the main task of governments should not be limited to the protection of the environment by suppressing any human activity or by suppressing transport upon which modern life and society depends. Their task should rather be to optimise any economic and human activity by promoting efficiency, especially in road transport.

To achieve this, policy-makers see the internalisation of external costs as a panacea and the tendency is to apply a limited and simplified approach to internalise external costs: the Polluter Pays Principle (PPP). This PPP is an easy to implement tax collection scheme but not an adequate response to the internalisation debate for the following reason:

**Today basic good governance principles demand that policy making must be based on some form of regulatory impact assessment. This is nothing less than an in-depth cost-benefit analysis and is central to the EU's "Better Regulation Initiative". However, the PPP runs counter to this established approach since the decision over who should pay has automatically been taken before any cost benefit analysis or impact assessment can occur.**

The basic rationale behind the PPP is that the polluter should pay the bill of the external costs he produces, which is usually done via a tax.

In this context it is, however, essential to recall the fundamentals of external costs.

- External costs are always the result of conflicting interests for the use of a scarce resource (such as the environment).
- Without rivalry for the use of a scarce resource there are no external costs and consequently all external costs are jointly caused by the polluter and the pollutee.
- External costs are to be considered as a loss of value to somebody caused by a change in the state/quality of the environment.

- Furthering the interests of one group – whether citizens or businesses - necessarily damages the interests of the others which is known as the reciprocal nature of the issue.

From an economic point of view, the PPP is an outdated, overly simplistic and narrow approach because it discounts those fundamentals and is not used in daily life or policy decisions (except by politicians intending to impose externalities on road transport!). In economic circles the shortcomings of the PPP have been exposed and its suitability as a sound basis for internalisation policies has been superseded by the Cheapest Cost Avoider Principle (CCAP) for which Ronald Coase received a Nobel Prize.

The fundamental principle of the CCAP is that:

**The CCAP requires that the party which can prevent (or abate) the damage at the lowest cost for the overall economy should take action.**

In this context it must be understood that **the mere existence of externalities does not, of itself, provide justification for governments to compel polluters bear the costs.** The polluter might well be the highest cost avoider and thus the least appropriate party to bear the costs. Yet, if the costs are still allocated to this party the economic damage will supersede the economic benefit gained, thus weakening the general efficiency of the economy to meet the challenges of sustainable development as a whole.

A simple example: Noise Emissions.

When a truck drives through open fields the question of noise emissions plays only a minor role. However, when the truck uses a road nearby a house there is a conflict of interest. The house owner wants quiet and the truck needs to emit certain noise in order to carry out his economic activity. One of the questions that needs to be answered is: Is it more effective to build a sound barrier to solve the noise problem, or does it make more sense to simply charge the truck owner? While the PPP would automatically attribute sole responsibility and all costs for the damage to the truck owner, the CCAP would require that a calculation is made to determine how and by whom the responsibility for removing the damage can be attributed most efficiently and with least cost to the economy overall.

**To conclude, the CCAP is an in-depth cost-benefit analysis which can be applied fairly and efficiently to each situation requiring an internalisation of external costs.** A CCAP analysis may result in the polluter being identified as the Cheapest Cost Avoider and thus the right party to pay the associated costs. In this case the road transport industry is ready to take its share of responsibility. It is only important to ensure that this responsibility is not made automatic - which is what the CCAP does. By contrast **the use of the PPP by policy-makers as an automatic response to all internalisation questions could lead to regulatory failure and to un-quantified and damaging economic costs.**

## II. IRU POSITION

To achieve sustainable development, economic growth and competitiveness in modern economies, the CCAP (based on a cost benefit analysis) must be applied in all questions concerning the internalisation of external costs in road transport instead of the economically outdated and unsound PPP.

---