# Are Market-Based Instruments the Right First Choice for Countries in Transition?

***Ruth Greenspan Bell***

In recent years, international assistance and lending organizations have strongly pressed central and eastern European countries to adopt market-based approaches to solve their environmental problems. However, few of the institutions necessary to carry out such changes existed or were strong enough to allow economic instruments to work. A better approach might have been to emphasize incremental improvements that could have been attained with the existing institutions.

It has now been more than 10 years since the fall of the Iron Curtain. Those of us who closely watched the transition can vividly recall the excitement and sense of possibility of those early days.

Environmental activism appeared to be an integral part of the systemic changes occurring throughout Central and Eastern Europe. Severe environmental degradation throughout the region had been an early rallying point for the democratic opposition, which used it to demonstrate the failures of state socialism. It seemed logical that these concerns would translate into a commitment by the new governments to strengthening environmental protection and cleaning up the mess left behind. In 1989, President George H.W. Bush gave a famous speech (at least in the environmental community) in Budapest that pledged U.S. help for efforts at environmental rebuilding.

Resources were brought to bear on the environment from a number of sources, including the European Union's PHARE program (which assists the applicant countries of central Europe in their preparations for joining the European Union), western European countries, the international financial institutions, Japan, and the U.S. Agency for International Development (AID). William K. Reilly, then-U.S. Environmental Protection Agency administrator, was instrumental in writing a commitment to protect the environment into the charter of the European Bank for Reconstruction and Development. Bedrich Moldan, board chair of the Regional Environmental Center for Central and Eastern Europe (REC), an organization originally set up with AID funding to support regionwide environmental reform, characterized these contributions as efforts to introduce the best environmental practices and ideas from the West.[1]

One issue ripe for examination is the quality and impact of the environmental assistance that started flowing to the countries of the former Soviet bloc after 1989. Many western observers and some central European experts apparently envisioned a tabula rasa that would support leapfrogging over the mistakes committed in the name of environmental protection in the west. (Their aspirations were much like those who apparently thought that markets in all their aspects would magically appear once communism was removed.) This hope was expressed, in part, through a push for the development of new ways to control pollution.

Much attention focused on the development of efficient regulatory instruments and attempts to avoid the mistakes of environmental regulation in the west. Many donors and advisors—including the Organisation for Economic Co-operation and Development (OECD), AID, World Bank, and the European environment ministers themselves—pushed and continue to push for the development of economic instruments, such as pollution taxes, marketable permits, and the like. Whether deliberate or not, the language used to discuss these environmental tools frequently obscured complex issues. The most notable example is repeatedly characterizing traditional approaches as "command and control" and contrasting them with "markets," for an audience reacting to years of hated central planning. Some advisors flatly promised that economic instruments would have lower institutional and human resource requirements than command and control, a glittering and ultimately incorrect promise in countries with small and underfunded environment ministries.

Ten years offers time for reflection. With a few interesting exceptions, the principal environmental improvements in the former Soviet empire have been not the result of improved regulatory tools, but a consequence of the collapse of unproductive state-owned industries and decreased reliance on heavy industry. Meanwhile, overall environmental institutions remain weak and most of the new ideas proposed after 1989 have not been implemented. Poland's substantial domestic investment in environmental improvement and Hungary's gains in energy efficiency are illuminating exceptions of gains made without great social costs.

Despite donor enthusiasm, most countries in the region were not ready to take on the challenge of environmental reform, for two primary reasons. The environmental movement no longer played the catalytic role it had before 1989. When Communist Party dominance ended, opposition leaders did not need environmental camouflage and could move into more direct roles in political life. The smaller number of people and organizations that continued to focus on environmental issues were pushed to the margin. The groups that remained tended to be top-heavy with technical experts and scientists, who were not very good at communicating with the broader audiences necessary to change policy.

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Even more fundamentally, exhilaration was eclipsed by the enormity of the challenges on every possible front—depressed economies, badly frayed social safety nets, and widespread concerns about social unrest. The extraordinary difficulty of doing everything at once (including instituting environmental change) in a time of intense social and economic change was not the "most conducive…to furthering the huge constructive and cooperative effort of institution building that society [was] now challenged to perform."[2]

## Introducing Market Mechanisms

Even as it became apparent that most countries in transition did not have the resources, motivation or public support to pursue environmental reform, donors continued, nevertheless, to push them toward the adoption of sophisticated tools. The effort to move directly to market-based instruments is worth examining as an illustration of the disconnect between hopes and expectations and on-the-ground conditions. It is a classic case in which optimism overtook good sense and little attention was given to institutional and social constraints.

What was overlooked was that markets do not act in a vacuum; institutions do matter for economic instruments, as they do for all tools of environmental protection. The example of emis-

[1] Europe After 10 Years of Transition, Speech at the REC on June 18, 2000. http://www.rec.org/REC/Programs/10th_anniversary/Speech.html

[2] Elster, Offe, and Preuss, *Institutional Design in Post-Communist Societies*.

sions trading, which was pursued in a number of countries and was the subject of several regionally based efforts, illustrates the gulf between advice and implementation.

One of the key motivations for industry to want emissions trading has been the economic pain firms have suffered from investing in compliance, which in turn is at least partly related to a clear expectation of consistent and reliable enforcement. When firms have to grapple with the reality—rather than the theory—of environmental regulation, they develop a good grasp of what are the real costs to them of regulation, and of what it takes, at a practical level, to achieve compliance. There is little evidence of industries theoretically coming to the conclusion that emissions trading will be a cheaper way of achieving compliance than directed regulation. Why try to save money on regulation if you are not expending any to begin with and don't expect to in the future?

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However, the environmental regulatory systems of the Soviet bloc countries were weak institutions. Laws were not the most important motivator of firm behavior and in any case were riddled with formal and informal exceptions. The state controlled everything and rewarded production over other values. Industry had not been hit on the head with the hard realities of environmental compliance. This is beginning to change in a few of the countries in transition. But even today in most of these countries, environmental enforcement is no more rigorous than it was during the Soviet period, and likely weaker because of the general confusion.

A second institutional requirement for emissions trading to work is very clear knowledge—not guesses—of what pollution each plant is discharging to the environment. Believable end-of-pipe monitoring assures that real, not imaginary, pollution reductions are being traded. But monitoring throughout the former Soviet bloc most often emphasized ambient measurements over end of pipe, and, in any case, was not consistent. In truth, no one could be sure what particular factories were emitting and whether they were meeting their discharge requirements. One could make estimations using the sulfur content of coal, but the accuracy of the estimations would depend on a number of assumptions, including that the control equipment had been turned on and had been maintained—not a trivial issue in the countries in question. The environmental equivalent of "trust but verify" was missing.

## Lack of Transparency

A whole series of measures and institutions are necessary to keep emissions trading honest. One of the most important in the United States is transparency. Permit requirements, emissions data, and the transactions themselves are all available for inspection by the public, including the firm's competitors. In the United States, where environmental regulation is a very contentious subject, this has helped to create a level of trust, a necessary predicate if government regulators, economic competitors, nongovernmental organizations, and the public interest community are going to go along with unconventional programs.

Government transparency was not a hallmark of the Soviet bloc governments, nor is it particularly a European tradition. Nine years into the transition, some of the countries in transition signed the Aarhus Convention in 1998, agreeing to increase their citizens' opportunities to obtain environmental information on demand. These countries are struggling with the nuts and bolts of implementation. It may be that emissions trading programs can work without as much transparency as the United States demands; in many countries, the public is more tolerant when industry and government sit down to negotiate. But it is clearly an issue that architects of any trading program must consider.

The connection between transparency and emissions trading is a particularly sensitive issue in the former Soviet bloc. Trading is, in some ways, a recognition that one party will be held to stricter standards than another similarly situated. When arrangements are made in the sunshine, there are fewer reasons to be concerned that these differentials will creep toward corruption. However, given their experience over the past 45 years, most citizens in the countries in transition are acutely aware how quickly this can happen.

In the mid-1990s, a project in Poland developed a legal basis for granting compliance schedules—essentially an alternative environmental compliance tool that involves grants of discretion. The Polish Ministry participants spent a considerable amount of time and energy devising safeguards to be sure that discretion would not be highjacked to serve the purposes of people in power, rather than the environment.

## Need for Legal Systems and Institutions

No firm with any degree of sophistication is likely to participate in emissions trading programs if transactions are not backed up by disinterested mediating institutions available to act in a timely manner to protect a wronged party. Emissions rights are complex intangible property rights and sometimes involve future rights. Buying and selling them is not the same as buying and selling apples in a local market. Emissions trading and other complex market-based mechanisms need a viable, reliable legal system or some analogous set of institutions to ensure the integrity of trades and protect everyone involved.

These certainly did not exist in the early days of the transition. Some of the westernmost countries in transition were only beginning to reestablish a European legal system free of the political and economic "'safety valves'—the legal means of last resort by which Party and state authorities could avoid their own rules"—that existed throughout the period of Soviet dominance.[3] Other countries, particularly Russia and the other parts of the Union of Soviet Socialist Republics had never really been subject to the reliable rule of law. While some countries have made progress in this regard, donor advice on emissions trading did not distinguish between countries with working legal systems and those without.

Trading systems are based on a real, rather than theoretical, understanding of how markets work and of how transactions are constructed, recorded, and policed—the very institutions of capitalism. Complex market transactions don't just happen; the actors must have considerable skills. Before 1989, scholars throughout the bloc studied non-Marxist economics, but the actual economy was structured under the rules of state socialism.

Industrial managers had been tutored in the old systems. They were not motivated by profit and loss, not held to western accounting principles, and not responsive to shareholders or the stock market. In general, they lacked the kinds of skills normally applied in complex emissions trading systems. The last 10 years have introduced masters of business administration programs and practical market experience, but not without a great deal of pain. A few countries retained a trading mentality that was reflected in small businesses, but, in general, industry has faced a steep learning curve and was not ready, certainly in the early part of the transition, to take on market-based environmental responsibilities.

[3] The phrase is Daniel H. Cole's in *Instituting Environmental Protection: From Red to Green in Poland*.

In sum, not only was there no tabula rasa, but there also were considerable although varied histories to overcome and institutions to build throughout the countries of the former Soviet bloc. The key elements—monitoring, transparency, a working legal system, and a realistic incentive to trade—were nowhere to be found. Scholars can debate whether the single-minded push of some donors to concentrate such intense efforts on developing sophisticated, market-based environmental regulation was a disservice, diverting energy from efforts that might have been more productive.

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In any case, pushing inexperienced governments prematurely toward highly sophisticated environmental policy tools was not the only miscalculation by the donor community. Another was the emphasis placed on drafting new state-of-the-art environmental laws without apparently giving much thought to the existing laws and how they operated, much less to what the countries could actually manage in terms of the resources and experience they could bring to bear in implementing the new laws.

My purpose here is not to argue against the use of market-based instruments. I don't advocate throwing the baby out with the bath water. Rather, I am arguing that market-based instruments were done a disservice when the OECD, World Bank, and others pushed these tools too hard and too fast in countries that were institutionally unprepared to implement them. The power of these instruments may have been trivialized when the experts were less than candid about the total package.

If environmental professionals in the countries in transition were led to believe that they could make this leap without at the same time constructing supporting institutions, the cause of environmental protection itself may have been dealt a blow by the disappointments that followed.

If the notion of a great environmental leap forward was not sensible, what approach might have worked better? Certainly, the old system could not be left in place. An emphasis on incremental improvements in pursuit of pragmatic goals might have been smarter, particularly one that helped to build a transitional system that would have taken account of existing capabilities and institutions. This might have resulted in real, although small, initial environmental gains, and might have been accomplished without losing sight of the ultimate goal of developing the most efficient ways to manage the environment. Another constructive approach would have elevated the importance of institutional reform in the advice rendered on economic instruments.

The donor community also needs to rethink its way of doing business. Formulaic advice should be replaced with crafted responses that explicitly recognize the varied conditions in each country that would support reform. Donors need to do their homework, as well, which means getting to know each country in a very different way than they have in the past.

The importance of examining these issues today is not only a question of historical review. Many of the same countries that were the subject of environmental assistance efforts are trying to enter the European Community. They will be required to incorporate into their environmental practices many highly sophisticated tools, layering them on to still-weak, thinly staffed domestic environmental institutions. Moreover, the same donors continue to urge countries with weak institutions in other parts of the world to adopt highly sophisticated tools for environmental protection. It would be wise to consider the lessons of environmental assistance in the countries in transition, as others embark on these new challenges.

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## For more information

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