



# Lobbying against environmental regulation vs. lobbying for loopholes

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## Abstract

We analyze the determinants of environmental policy when two industry lobbies can seek a laxer policy that would apply to both industries and loophole lobbying that provides benefits specific to one industry. We determine the properties of the lobbying equilibrium, including the resulting emissions level. In many cases, higher effectiveness of loophole lobbying is detrimental for industries and beneficial for environmental quality, as it exacerbates the free-rider problem in the provision of general lobbying by inducing industries to turn towards loophole lobbying.

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## 1. Introduction

Representatives of polluting industries usually want environmental policy to be lax, but have different preferences about how to distribute the burden of any legally required

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emissions reduction among them. For instance, economy-wide energy taxes can be designed in different ways, with various kinds of sectoral exemptions. A case in point is the German Eco Tax, which contains many explicit or implicit loopholes for particular industries.<sup>1</sup> At first glance, the freedom of policy makers to grant such loopholes would appear to be disadvantageous for the environment. However, this is less clear if environmental policy is endogenously influenced by the lobbying activities of interest groups.

We shall propose that, when an environmental policy can be implemented in many different ways with different distributional implications for the affected industries, the political-influence activities of each industry will be diverted from resisting regulation as such towards lobbying for industry-specific loopholes. As a result, when there is considerable scope for loopholes, the equilibrium policy may be stricter than when there is not. Intuitively, greater scope for loopholes means that the incentive for free-riding on other industry lobbies in the resistance to regulation is larger.

We make this argument more precise in a model with two lobbies, each of which represents an industry. An industry lobby has two instruments to influence the tax it faces, *general lobbying* and *loophole lobbying*. These activities translate into industry taxes by means of a policy formation function with the following properties. First, total general lobbying of the two industries determines a base level of the tax that is an upper bound for both industry taxes; higher general lobbying corresponds to lower taxes. By definition, therefore, general lobbying is a public good from the point of view of the industries. As such, it is prone to underprovision. Second, by definition, loophole lobbying of an industry only reduces the tax for this particular industry, as it reflects efforts to gain tax exemptions. The effect of loophole lobbying on the other industry is assumed to be at best neutral, but typically negative: The more the other industry lobbies for favors, the more effort is required by a group to obtain similar concessions.<sup>2</sup>

Each industry is imperfectly competitive with constant marginal costs, including an output-dependent environmental tax. The industry profit, gross of lobbying costs, is a decreasing function of marginal costs. Therefore, an industry's gross profits are an increasing function of total general lobbying and of its own loophole lobbying, but a non-increasing function of the competing group's loophole lobbying. Industry lobbies simultaneously choose general lobbying and loophole lobbying expenditures so as to maximize industry profits, net of lobbying expenditures. An exogenous parameter  $\theta$  measures the scope for loophole lobbying. For *given levels* of each type of lobbying, higher values of this parameter mean that loopholes for each industry increase and thus taxes decrease. Also, the absolute value of the marginal effect of loophole lobbying on taxes is higher.

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<sup>1</sup> Apart from a preferential treatment of the manufacturing industry as opposed to the service industry, the Eco Tax contains a complicated set of special regulations which amount to loopholes for specific sectors (Friedrich-Ebert-Stiftung, 1999, Chapter 1, Table 1; Bundesweltministerium, 2002).

<sup>2</sup> Both types of lobbying can take various forms: information campaigns, legal or illegal contribution payments, or the promise of cooperation in other policy areas. Very roughly, one would expect loophole lobbying to be more secretive: The smaller the group in society whose interests the lobbying activities represents, the less likely it is that public information campaigns will receive much public attention.

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