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**REPORT BY THE (ECOFIN) COUNCIL TO THE EUROPEAN COUNCIL IN NICE
ON ENVIRONMENT AND SUSTAINABLE DEVELOPMENT**

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Background and main conclusions

The present report responds to the request by the European Council in Cologne in June 1999 to report in 2000 on the integration of environmental issues and sustainable development into Ecofin policies.

The report is a first step in the development of a comprehensive Community strategy aimed at improving the integration of environmental issues and sustainable development with economic policies. This was requested by the European Council in Helsinki in December 1999 for the European Council in Gothenburg in June 2001. The Ecofin Council because of its overall responsibility for both macroeconomic policy co-ordination and fostering comprehensive microeconomic reform, intends to actively work towards the development of such a comprehensive strategy.

The Ecofin Council considers it important to:

- assess the economic and social consequences of environmental damages and environmental policies,
- avoid, as far as possible, detrimental effects of environmental policies on employment and productivity by using clear ecological targets, adequate instruments, international cooperation and adequate accompanying macro-economic policies.

The Broad Economic Policy Guidelines, which are at the centre of economic policy co-ordination, are well placed to develop a comprehensive, transparent and credible Community framework for improving the integration of environmental and sustainable development issues with economic policy. The guidelines should encourage a consistent policy approach across sectors which is based on an increased use of market based instruments. Environment policy should be gradually implemented with clear intermediate and final targets. The guidelines should ultimately include concrete objectives, timetables and mechanisms for monitoring progress in this area.

The Ecofin Council also intends to better integrate environmental and sustainability related issues in the multilateral surveillance process. To this end, it will promote the development of appropriate statistics, including environmental accounts.

Finally, the Ecofin Council intends to strengthen its efforts to agree an appropriate framework for energy taxation at the European level on the basis of the Commission's proposal on energy taxation.

In preparing the report, the Council has drawn on the Commission Communication "Bringing our needs and responsibilities together" integrating environmental issues with economic policy" and on work done by the Economic Policy Committee.

1. Economic and environmental objectives

Objectives of economic policy

Article 2 of the EC Treaty spells out a number of policy objectives which should guide the formulation of Community policies. Ensuring a harmonious, balanced and sustainable development

of economic activities as well as a high level of protection and improvement of the quality of the environment are among these objectives which also relate to employment, social protection or social cohesion. In many instances, a large degree of complementarity between these objectives will appear. In other cases, this relation may not be straightforward or there may be trade-offs which call for choices on the appropriate weight allocated to these objectives.

In some cases, measures to improve environmental quality are likely to lead, at least in the short run, to a reduction in economic growth, as conventionally measured, because they imply the use of economic resources and changes in economic structures, which may cause significant economic costs. In certain cases, such as green-house gas emissions, where more effective cleaning techniques still need to be developed, such trade-offs between economic growth and the environment may persist into the long run. Nevertheless, experience shows that in many cases it has been possible to combine economic growth with improvements in environmental quality. Economic growth and higher income levels increase the ability and willingness to pay for a cleaner environment. But in the absence of corrective measures or technological improvements and innovations that promote sustainable development, economic growth is likely to result in an increased consumption of natural resources and increased pollution.

The need for an active environmental policy

The concern for environmental issues and the need for a sustainable development has increased over the last decades. Challenges like climate change or the depletion of the ozone layer have convinced citizens and politicians that an active environmental policy is needed, in particular at the international level, in order to ensure a responsible use of scarce natural resources and an economic development which is environmentally and socially sustainable in the long run. Commitments undertaken at international level, e.g. in the context of the Kyoto Protocol on climate change also call for policy action.

This growing concern for environmental issues has been reflected at Community level by the inclusion in the Amsterdam Treaty of the requirement to integrate environmental protection into the definition and implementation of Community policies and activities, in particular with a view to promoting sustainable development (Article 6 of the Treaty).

A policy aiming for sustainable development should not be limited to environmental issues, but also take into account economic and social aspects, like economic growth, high employment, price stability or the competitiveness of the European Union. In this context, the Ecofin Council recalls that a new strategic goal has been defined by the European Council in Lisbon, i.e. "to become the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion".

The best-known definition of "sustainable development" comes from the World Commission on Environment and Development (the "Brundtland Commission"). It defined sustainable development as development which "meets the needs

of the present without compromising the ability of future generations to meet their own needs". One way of approaching the issue is to regard human activity as giving rise to the accumulation and/or depletion of economic, social and environmental assets or values. In this perception, a policy aiming at sustainability would have to strike the right balance between increases and reductions in the quantity and quality of these three types of asset, while taking into account that the extent to which the three types of asset may be substituted for one another may be limited, in particular in case of any irreversible losses of environmental quality.

Integrating environmental and economic policies

Our economic systems are guided by the Treaty principle of an open market economy with free competition. Economic policy defines the framework conditions in which economic agents operate. It is mainly concerned with the functioning of markets and the overall macroeconomic stability. In this context, many environmental challenges arise because property rights or markets do not exist for some natural resources, like clean air, or because market prices and private costs do not reflect social costs (e.g. congestion, noise, pollution). These challenges are magnified when they occur cross-border or across several legal jurisdictions.

In case of divergences between private and social costs, markets cannot ensure an efficient allocation of resources. Goods and services which generate negative externalities (i.e. costs which are not borne by the producer or consumer but by others) may be produced in excessive quantities, whereas the production or consumption of goods and services which generate positive externalities may be lower than optimal.

The non-application of the Polluter Pays Principle and the misallocation of costs of production constitutes an implicit subsidy for polluting activities at the expense of society as a whole. It may also imply that new generations pay for an environmental degradation in which they did not take part: it therefore may also constitute an implicit transfer of wealth from young to old generations. The application of the Polluter Pays Principle is also meant to deal with this equity issue.

Allocating the costs of increased pollution according to the Polluter Pays Principle should be done in such a manner that it keeps aggregated costs as low as possible. The application of the Polluter

Pays Principle should not necessarily result in reduced growth for the economy. Often, it makes costs, which formerly have been borne by the victims of pollution or by society as a whole, more apparent. The proper allocation of costs will allow economic agents to take them into account in the production or consumption process. This should improve the overall efficiency of the economies. However, the practical implementation of this principle is often hampered by difficulties in obtaining good estimates of external costs.

In general, economic policy should address environmental issues from both the producers' and the consumers' perspective. Environment policies need to be developed with the participation and consultation of all stakeholders. They also have to pass the cost-benefit test, as all policy proposals have to take account of the potential economic, social and environmental benefits and costs of action and lack of action. In consequence, only those policies and measures should be implemented based on sound and transparent analysis, and that promise to be welfare increasing.

Of course, environment policies, however they are implemented, have distributional consequences. Even though society as a whole will gain by using market forces to achieve environmental policy objectives, some agents may lose. In order to make environmental policies socially acceptable, accompanying policies might have to be developed.

2. Available instruments

Different instruments are available for policy makers to obtain environmental objectives and in practice, environmental policy will involve a mix of various complementary instruments:

- a command-and control approach relying on technical standards or on limit values,
- market based instruments which try to influence supply or demand through appropriate incentives,
- negotiated agreements between public authorities and industry,
- the provision of information on the environmental impact of goods and services.

Command and-control approaches

Command-and-control approaches typically prescribe emission standards or they work with technical standards which are regarded as environmentally efficient to limit and to reduce pollution. They often rely on the philosophy that "best available

technology" or "best available technology not entailing excessive costs" should be employed. On the other hand, they are in general not efficient from an economic point of view, unless the policy makers have full information concerning abatement costs. Nor can technical standards guarantee that specific goals regarding environmental quality are achieved. Furthermore, they usually impose the same standards for all sectors and all firms, whereas abatement costs are not the same everywhere. Finally, they do not give a permanent

economic incentive for developing technical improvements which surpass existing norms. In general the more prescriptive and inflexible the regulations, the higher the costs of achieving a given outcome.

However, there are certain cases, where severe threats to health and the environment justify a regulatory approach, e.g. for the reduction of CFCs and in many other cases, where taxes or tradeable permits are, for one reason or another impractical, regulation may be unavoidable. In these cases it is important that the regulation is as efficient and flexible as possible.

Market-based instruments

Economic instruments fall broadly into two categories $\{\{SPA\}\}$ those which control the quantity of pollution but leave the price to be determined by the market, and those which set a price to be paid for the "right to pollute", but set no limit on the amount of pollution which may be caused, provided that this price is paid. Both categories necessitate government intervention. The choice between one or other type of instrument will in the first instance depend on her greater importance is attached to a target on the quantity of pollution or on its price. This in turn will depend on the nature of the pollutant to be controlled and its impacts on the environment and society.

The category of quantity-based measures includes the creation and assignment of tradable property rights, and tradable emission permits. Instruments such as taxes and subsidies belong to the price-based measures.

Creation of property rights and tradable emission permits

In principle, environmental externalities due to missing markets can be taken account of by creating the conditions for a market to emerge, that is by creating and assigning well-defined property rights. Nevertheless, in practice it may be difficult to reduce environmental pollution in this way, because of transaction and enforcement costs, in particular, if a large number of polluters and of those affected by pollution are involved.

Tradable emission permits offer a market-based means of implementing environmental policies which have an absolute quantity of pollution as their policy objective. They require that the pollutant in question is not associated with the creation of environmental "hot spots". Thus tradable emission permits are a suitable instrument for dealing with climate change, but their use for addressing pollution of ambient air in urban areas or river basins, for example, may be problematic.

The Commission $\{\{PU2\}\}$ s "Green paper on greenhouse gas emissions trading within the European Union" is a good starting-point for a continued discussion on the design of such a market.

Price-based instruments - taxes, subsidies and charges

Taxes place a price on pollution and thereby remove or reduce the gap between private and social costs. Similarly, subsidies place a price on environmentally-beneficial activities.

Subsidies may also be used to address negative externalities, by paying for part or all of the cost of abatement technology, for example. This can in principle achieve the economically efficient level of pollution. Subsidies, however, by assigning rights to the polluters may impose part of the cost of pollution on the society at large and not on the polluters. In contrast, a pollution tax respects the polluter pays principle, and may generate revenues which may be used for more ambitious environmental expenditure policies or to reduce other distorting taxes. These instruments work best on competitive markets with price elastic demand.

Price-based instruments may be superior to the use of other market-based instruments in particular where there are many small polluters, such as consumers.

Negotiated agreements

Negotiated agreements between public authorities and industry represent something of a "half-way house" between market-based instruments and regulation. Typically, such agreements offer their participants a greater choice than regulation in meeting the agreed environmental objectives. Moreover negotiated agreements can be more cost-effective than regulation and offer a forum to build consensus, co-operation and to encourage innovation. To be effective, these agreements should define quantified targets which can be monitored.

However, when used alone, negotiated agreements may be subject to criticism on several grounds. *Ex-ante*, not all industrial sectors are equally able to negotiate such agreements, since a pre-requisite is that all or almost all the firms in the sector be members of a strong industrial association with which the authorities can negotiate. There is a risk that the effectiveness of environmental policy becomes excessively influenced by the ability of industry lobbies to secure relatively favourable treatment for their members. In particular, smaller industries and households may bear a disproportionate share of the burden. Additionally, negotiated agreements are not consistent with the principle of internalising external costs, since any unabated pollution is not paid for by the polluters.

On the other hand, under certain circumstances those negotiated agreements can also be appropriately combined with the use of other instruments, e.g. taxation and may also make an anti-pollution policy much more acceptable to powerful vested interests.

Information

Reliable, transparent information is an essential element in efficient markets. Consumers need information on the environmental effects of different goods and services in order to take environmental aspects into consideration. The effectiveness of market-based approaches to environmental policy depends *inter alia* on the availability of substitutes, and on consumers/producers knowing about them.

Governments can either provide framework conditions inciting producers to provide relevant information on environment related issues or they can take an active role in providing such information. Eco-labelling programmes, either government supported or privately run, can improve information available to consumers and guide their choices. Successful examples are the Blue Angel, the Nordic Swan or labels on energy efficiency or recycling.

Information does not seem to be a sufficient instrument when it comes to changing consumption and production patterns in a more fundamental way. On the other hand, other policy instruments may be more accepted if their use is accompanied by the provision of relevant information.

3. Principles for future policies

Depending on the national and international circumstances (market structure, preferences of citizens, cost of available instruments, price developments for natural resources) a mix of instruments may have to be used. Modern regulation or other non-market-based instruments will continue to play a role where inefficient or even non-responsive markets prevail, or where it is imperative that a specific environmental quality is not deteriorated below a certain level.

Policy instruments which rely on market mechanisms and which provide incentives to economic agents to reduce pollution will generally be more cost effective than those relying solely on regulatory means. For these reasons, the Ecofin Council believes that market based instruments allowing for decentralised choices by economic agents should constitute a major component of any comprehensive policy aiming at integrating environmental concerns into economic policies, and ensuring sustainable development.

The effectiveness of market-based instruments depends crucially on the competitive conditions and the price responsiveness of markets. Increasing competition by deregulating markets, lowering of entry and exit barriers, and better enforcement of competition laws will increase the efficiency of market based instruments.

The choice of policy instruments to reach specific environmental objectives should be based on a case by case approach. The Ecofin Council underlines the view that well-formulated analyses of costs and benefits are of major importance to define optimal instruments and measures. Often a mix of instruments will be needed. The choice has to be based on high quality quantitative economic and scientific analysis of the costs and benefits of action or lack of action. Benefits may arise from welfare increases due to lower pollution. Costs may be either of a financial nature or may consist of an increase of administrative or transaction costs. Any measure taken to reach specific objectives should be cost-effective. However, decisions will in many cases be characterised by a considerable degree of uncertainty and where there is a risk of irreversible damage, the Precautionary Principle should be respected.

Against this background an ex-ante involvement of the Ecofin Council is important to assess carefully the instruments and macro economic consequences of new and important environmental policy actions, such as post-Kyoto initiatives. It welcomes the studies undertaken by the

Commission on this subject, and calls on the Commission to continue working with all stakeholders notably within the European Climate Change Programme to develop proposals for cost-effective policies and measures which will enable the Community to meet its commitments under the Kyoto Protocol. Within this context, the Ecofin Council invites the Commission to examine the potential advantages and disadvantages of a Community-wide emissions trading system.

Whatever mix of policy instruments is used, environmental policies will entail distributional consequences which might endanger their acceptability. Accompanying policies might alleviate these problems.

First, wherever appropriate, environment policies should be gradually implemented with clear intermediate and final targets. A gradual implementation of environment policies may help to avoid sudden changes in competitive conditions in which firms have to operate. Therefore, a gradual approach is preferred over an accelerated implementation which would be accompanied by exemptions for some sectors of the economy. Also if regulatory instruments are used, a gradual implementation would be preferable to allow for the development of cost-effective technologies, thereby mitigating some of the disadvantages of regulatory instruments.

Typically the sectors which claim exemptions are those which are responsible for a large part of the pollution. Given a certain environmental target, allowing exemptions for large polluters may be inefficient from an economic point of view because it puts an extra burden on other parts of the economy to adjust and it will increase the overall costs for society.

It has been argued that in a second best situation, where different countries have implemented the Polluters Pays Principle to varying degrees, exemptions may be justified in order to avoid imposing on countries which already have chosen to introduce ambitious environmental taxes large costs in terms of loss of competitiveness for specific industries. On the other hand, such exemptions protect certain sectors at the expense of the economy as a whole, given that the target must then be met by other means.

In many instances, a coordinated approach at Community level could alleviate competitiveness issues by creating a level playing field within the Community. It is recalled that exports to and imports from third countries are each equivalent to less than 10% of Community GDP, and costs related to natural resource use or environmental degradation are in the present context a relatively minor share of total costs. Moreover, our main trading partners, including all the major industrialised countries, are supposed to take steps towards protecting the global environment and meeting specific Kyoto targets. The fear that the implementation of high standards of environmental protection may lead to a general deterioration of the competitiveness of European business should therefore not be exaggerated, but specific sectors and, under certain circumstances, also individual Member States may be significantly affected. Possible negative effects of specific environmental policies on growth and inflation, may need to be offset by macro-economic policies aiming at avoiding any loss of competitiveness for the economy as a whole.

Subsidies may be justified in some cases, e.g. to stimulate the development and implementation of environmentally sound technological improvements and innovations. In very specific cases, subsidies may also be justifiable for compensating economic agents that invested without anticipating the changes in environmental legislation. However, given the difficulty in evaluating

"sunk costs" and therefore in determining the proper level of subsidies, a gradual approach may appear to be a useful second-best solution. Moreover, any subsidy scheme would have to respect Community rules for State Aid.

Finally, environmental policies should be assessed in the light of their employment and social implications, so that, as much as possible, an integrated approach is realised. This should make the necessary structural change socially and politically easier to accept.

Subsidiarity as an important criteria for defining responsibilities

The principle of subsidiarity is important in defining responsibilities for policy action. Responsibilities for environment policy should stay as close as possible to the citizens in order to take better account of different preferences. Often action will have to be taken at local or regional level. In cases like country or town planning, the local or regional level may be best placed to define or implement policies. In other instances, however, and depending on the scope of the environmental problem, action at national and cooperation at Community or even global level may be necessary or even indispensable.

In many cases cooperation at the widest possible scale will enable or facilitate policies for sustainable development. Cooperation allows countries to tackle effectively environmental problems which have cross border effects, for example greenhouse gases and climate change. In some cases, cooperation may be necessary because countries have to bear the costs of environmental pollution that has been caused by other countries.

International cooperation may also allow an exchange of best practice regarding other environment policies. Finally, co-ordination of environment policies may be necessary because of their implications for other policy areas, e.g. internal market rules, competition or state aid rules, etc. or in order to create an equal playing field between competing companies located in different countries. The principles of subsidiarity and proportionality ask for a careful examination in which cases which method of cooperation is preferable.

Sustainable development in the BEPG

The Ecofin Council has repeatedly pointed to the need to promote sustainable development through a better co-ordination of policies at Community level. In the Broad Economic Policy Guidelines, which are at the centre of economic policy co-ordination and which provide for the overall policy objectives and orientations to the Member States and the Union, the Ecofin Council has included this year a separate section on sustainable development which will be further developed and integrated with the BEPG in the coming years.

In the framework of the BEPG, the Ecofin Council has underlined that the promotion of environmentally-friendly technologies, products and behaviour could contribute to a more sustainable development. It argued that a sound environmental policy that tries to exploit the efficiency gains embodied in market-based instruments would also bring benefits in terms of more efficient economic structures, hence contributing to higher growth and employment.

The Ecofin Council has also endorsed three specific guidelines which are addressed to all Member States and which urge Member States to:

- i. introduce or strengthen market-based policies like taxation, user charges, insurance/liability schemes and tradable permits, which put a price on scarce resources; help achieving the EU objectives under the Kyoto protocol; and contribute to break the link between environmental pressure and economic growth;
- ii. reassess sectoral subsidies and tax exemptions and other existing measures which have a negative environmental impact whilst taking full account of other relevant economic and social factors; and
- iii. work to agree on an appropriate framework for energy taxation at the European level.

Monitoring of implementation is important

The monitoring of the implementation of these guidelines will be carried out, as from next year, in the framework of the multilateral surveillance procedure foreseen in Article 99 (3) of the Treaty. The Ecofin Council calls upon the Commission to pay increased attention on environmental and sustainability issues in its forthcoming implementation report on the BEPG which is an important instrument for this surveillance process. The Economic Policy Committee, which conducts regular country examinations on structural reforms, is asked to include the examination of environmental effects of prevailing policies and market structures in one of the forthcoming years in the country examinations. These examinations could also allow an exchange of experience and an identification of best practice in this area.

In order to facilitate monitoring, in the framework of a working group set up in the Economic Policy Committee, indicators are being considered which are linked to the BEPG and which relate to the use of market based instruments and the state of the environment. The Ecofin Council is submitting a separate report on "Structural Performance Indicators: an Instrument for Better Structural Policies" to the European Council in Nice. Indicators on the environmental, social and economic dimensions of sustainable development will be an important element in monitoring the implementation of the BEPGs.

Other Council formations are invited to support Ecofin's efforts to monitor the implementation of the BEPGs related to sustainable development. In accordance with the arrangements defined in the 2000 BEPG, the Ecofin Council invites all relevant Council formations, and in particular the Environment Council, to make their contributions available at the end of January of each year. This would help the Ecofin Council to prepare its own contribution for the regular spring meeting of the European Council and the next set of BEPGs.

The Ecofin Council intends to further develop in the following years the environment and sustainability related parts in the BEPG including the recommendations on the quality of public finance. The BEPG, because of their broad nature, are well placed to develop a comprehensive Community framework for improving the integration of environmental and sustainable development issues with economic policy. Environment policy should be gradually implemented with clear intermediate and final targets. The guidelines shall encourage a consistent policy approach across sectors which is based on an increased use of market based instruments. The guidelines could moreover, if needed and without overburdening the process, be more specific in the country related guidelines as this is the case already for other policy areas.

An appropriate framework for energy taxation

The restructuring of national tax systems may, amongst other things, contribute to a better integration of environmental objectives in economic policy whilst respecting the need for economic efficiency. Increases in environmental taxes need not imply an overall increase in the level of taxation. A revenue neutral shift to environmental taxes could in particular be considered as an instrument, amongst others, to improve energy efficiency and to reduce greenhouse gases. It could thereby contribute to meeting the objectives under the Kyoto protocol. Several Member States started to implement such a policy of "tax shifting" in the early and mid-1990s.

The development of an appropriate framework for energy taxation at the European level could facilitate the restructuring of national environmental taxes or tax systems as a whole. The Commission has adopted on 12 March 1997 a proposal for a directive on restructuring the

Community framework for the taxation of energy products. On the basis of this proposal, the Ecofin Council intends to continue its work to agree on an appropriate framework for energy taxation.

The Commission is called upon to provide an update of recent developments in environment relevant tax systems in Member States and in third countries and to provide a study, which allows the Ecofin Council to examine the environmental effects of national tax systems and subsidies.
