



Institute for
European
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Policy

FEASIBILITY OF IMPLEMENTING A RADICAL ETR AND ITS ACCEPTANCE

**Report under task C of the *'Study on tax reform in Europe
over the next decades: implication for the environment,
for eco-innovation and for household distribution'***

Final report

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ACRONYMS

BAT.....	Best Available Techniques
BEPG	Broad Economic Policy Guidelines
CFCs	Chlorofluorocarbons
CFSP	Common Foreign and Security Policy
CIS	Common Implementation Strategy
CO ₂	Carbon Dioxide
EAP	Environmental Action Programme
EC	European Community
ECCP.....	European Climate Change Programme
ECJ	European Court of Justice
EEA.....	European Environment Agency
EES	European Employment Strategy
EFR.....	Environmental Fiscal Reform
ETR.....	Environmental Tax Reform
ETS	Emission Trading Scheme
EU	European Union
FDE.....	Fuel Duty Escalator
FSC	Forest Stewardship Council
GDP.....	Gross Domestic Product
GHG.....	Greenhouse Gas
GNP.....	Gross National Product
GPP	Green Public Procurements
IGC	Intergovernmental Conference
IMPEL.....	Implementation and Enforcement of Environmental Law Network
IPPC	Integrated Pollution Prevention and Control
MBI.....	Market-Based Instruments
NGO.....	Non-Governmental Organisation
NO _x	Nitrogen Oxide
OMC.....	Open Method of Coordination
PES.....	Payment for Environmental Services
PM.....	Particulate Matter
REDD.....	Reducing Emissions from Deforestation and Degradation
RES	Renewable Energy Sources
SCR	Selective Catalytic Reduction
SDS	Sustainable Development Strategy
SO ₂	Sulphur Dioxide
TEC	Treaty establishing the European Community
TEU	Treaty on European Union
VAT	Value Added Tax
WFD	Water Framework Directive

EXECUTIVE SUMMARY

In a European future with an increasingly ageing population, pressing environmental problems, growing resource scarcity and the need for increased energy security, a shift in the tax base from labour to environmentally damaging activities – i.e. an Environmental Tax Reform (ETR) – could arguably help address both economic and environmental concerns.

This report aims to understand the scope for using ETR to address current and future environmental challenges, and looks at possible paths to develop a more harmonised approach to ETR in the EU. The information portrayed here was obtained through interviews and questionnaires to more than 30 experts and officials of national and EU institutions, NGOs and other organisations, and complemented by a literature review.

To date, only few Member States have adopted some form of ETR and the level of uptake of green taxes is very uneven. On average, the share of green taxes in Europe has not grown in the past 10 years and currently only accounts for 6.7 per cent of total tax revenues.

Experts' views indicate that a doubling of the current share of environmental taxes – up to 15 per cent of total tax revenues – would be desirable and feasible in the medium-long term.

Green taxes, however, should not be treated as a panacea for all environmental problems. Ideally, they should be applied in those policy areas where they are expected to be more effective, and work in parallel with other market and non-market instruments, including regulation, ETS and the removal of harmful subsidies.

In general, there is substantial scope for ETR to help tackle climate change, especially the mitigation aspect – where taxes on energy/emissions can complement ETS, i.e. addressing non ETS-sectors and/or non CO₂ emissions. Taxes can also be useful to stimulate resource efficiency by placing the right price signal to scarce resources such as water, minerals and gravel. Water pricing, for instance, can help tackle water scarcity, which is an increasingly serious issue in Europe. Waste taxes – e.g. landfill taxes and charges – can also help curb the production of waste and stimulate re-use and recycling. For other sectors - such as biodiversity, chemicals and renewable resources – the effectiveness of fiscal instruments is less evident and will need to be assessed, and other instruments should be taken into account. In general, the introduction of environmental taxes should be made on a case by case basis, carefully evaluating the most effective tool for each specific environmental area and objective.

Despite its potential, several barriers and criticisms of ETR still exist, such as the fear of negative impacts on competitiveness, potential effects on inflation, impacts on low income groups, possible increases in the cost of production (e.g. if energy becomes more expensive), or simply political caution near elections.

Many examples and good practices have proved how the perception of some of these obstacles is in some places wrong, or showed the way to overcome them. However, there is still a general lack of confidence in a substantial shift towards more radical

ETR in the short term. There is also a general lack of vision as to what a more appropriate tax structure could be in the absence of political pressure and vested interests.

The adoption of initiatives at EU level has also proved difficult and, in practice, progress in the development of EU-wide ETR measures and green taxes has remained excruciatingly slow. Provision for the harmonisation of legislation concerning indirect taxation can only be adopted by the Council acting unanimously on a proposal from the Commission¹. The co-decision procedure does not apply to fiscal provisions, and the European Parliament is merely to be consulted. Similarly, Council must act unanimously² if it wishes to adopt measures of a fiscal nature to pursue environmental policy objectives. This explains why very few Community measures aimed at ETR have effectively been adopted so far.

Notably, the Commission's proposal in the 1990s for a directive introducing a tax on carbon dioxide emissions and energy was buried in the Council and eventually withdrawn. The adoption of the Emission Trading Scheme (ETS) Directive³ in 2003 reflects a conscious political choice to abandon attempts at ambitious ETR at Community level by replacing a carbon/energy tax with a cap-and-trade system applying to large point sources of CO₂ in certain sectors of economic activity only.

ETR and environmental taxes have therefore been to date a national matter, with the only exception of some minor harmonisation achievements under the Energy Taxation⁴ Directive, the Eurovignette⁵ Directive and also under the Water Framework Directive (WFD), though here there is still considerable untapped potential for reform.

Increased harmonisation, however, can be an important element to encourage Member States to adopt more radical ETR. A more harmonised approach can potentially reduce the risk of distorting competition and can generate a common playing field in the EU. Given the difficulties encountered in the past with proposing common environmental taxes, however, a legislative approach at the EU level for ETR appears difficult to pursue today. There continues to be considerable political resistance from Member States against initiatives that could be interpreted as a formal transfer of competences in tax matters from the national to the EU level. Therefore, alternative paths seem to be needed if further harmonisation on ETR is to be achieved.

¹ As set under article 93 of the Treaty establishing the European Community

² Under Article 175(2) of the Treaty establishing the European Community

³ Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC. OJ L 275, 25.10.2003

⁴ Council Directive 2003/96/EC of 27 October 2003 restructuring the Community framework for the taxation of energy products and electricity OJ L 283 , 31/10/2003

⁵ Directive 1999/62/EC of the European Parliament and of the Council of 17 June 1999 on the charging of heavy goods vehicles for the use of certain infrastructures. OJ L 187, 20/7/1999

The Study explored two options for further harmonisation: the Open Method of Coordination (OMC) – i.e. a form of collaboration among Member States aiming to share and information and agree on common (non-binding) objectives – and enhanced cooperation – i.e. a closer interaction among a group of like-minded Member States (at least eight) that can lead to binding commitments for those involved.

Enhanced cooperation, while possible in principle, currently looks difficult to implement in practice, due to its demanding requirements. The difficulty of this approach lies in the difficulty to ascertain, as required in the treaty of Nice, that the matter cannot be solved ‘*within a reasonable period by applying the relevant provisions of the Treaties*’. This would require a *de facto* admission of failure of the EU institutions to deal with some fiscal matters, which may encounter political resistance. A formal Council conclusion to this effect is required before any further steps can be taken. In parallel, the initiators also need to request the Commission to submit a formal proposal for an act to be adopted under the enhanced cooperation procedure. The discretionary power that the Council and Commission must exercise in order to trigger an enhanced cooperation procedure is substantial. The legal constraints associated with enhanced cooperation therefore are high. In addition, there are considerable political constraints - not least a significant unwillingness among Member States to agree on an enhanced cooperation for fear that this would set a precedent for using the instrument more widely. These factors have so far prevented Member States from taking recourse to enhanced cooperation.

A less controversial approach will be the Open Method of Coordination, which has already been applied on a range of policy areas. The OMC is meant to help Member States to progressively develop their own policies, and is inclusive with regard to participation by all Member States. Pursuing ETR through an OMC is expected to encounter less political resistance, as it would leave formal competences for tax matters firmly at the national level. Unlike enhanced cooperation, however, OMC is only a ‘voluntary’ approach, as it does not directly result in the adoption of legally binding rules. Consequently, OMC can potentially be a ‘weak’ approach and lead to little result. The OMC, therefore, is unlikely to succeed if it is not backed by a sufficiently broad consensus on the necessity of the framework goal of medium to long-term radical ETR and sufficient institutional capacity and stability. This will require a level of commitment beyond that applied in many existing OMCs.

Opportunities for enhanced cooperation may arise in the future as EU enlargement continues, while currently there may be some scope for softer measures, such as the OMC and simple ‘copy-cattig’, to improve collaboration and experience sharing among Member States.

Overall, the political climate over the past ten years appears to be less inclined towards a more substantial tax shift from labour to environment, although interest on carbon taxes and ETR seems to be rising again in some countries, like France. However, long-term environmental objectives agreed at national and EU level make imperative to use the measures available, including environmental taxation, to achieve the target set. If in the short run it is difficult to expect immediate significant and widespread changes in the tax composition, it is desirable that in the medium-long term the relative share of environmental taxes increases in order to provide the right

signal to the economy. There is a need for a paradigm shift in politicians' willingness to support ETR. There is an opportunity now with the current economic crisis, though the risk is that governments focus on new subsidies, rather than on reforming environmentally-harmful subsidies and the wider tax system.

The joint challenge of climate change, resource constraints, need for innovation, energy security, environmental impacts, as well as an aging population, may together create the conditions for a new momentum for a radical approach on ETR. Recent growing interest in new carbon taxes, carbon-based vehicle taxes and product taxes, as well as a move to full cost recovery for water pricing, all indicate a growing political awareness of the need to progress on ETR. EU enlargement, with its associated increased difficulty to get unanimous agreements, will make an EU-wide legislative approach for ETR increasingly difficult. The tension between a more recognised need for ETR and growing difficulty of an EU-wide approach, together with the limits of 'soft' approaches such as OMC, may create the conditions for exploring 'enhanced coordination' and even open the door to changes in legal procedures to ease the use of formal enhanced cooperation.

1 INTRODUCTION

1.1 Aims and objectives of the work

This report is part of the wider *Study on Tax Reform in Europe over the next decades: implication for the environment, for eco-innovation and for household distribution*, a project for the European Environment Agency (EEA), led by Kommunalkredit Public Consulting (KPC) in collaboration with the Institute for European Environmental Policy (IEEP), Gesellschaft für Wirtschaftsforschung (GWS), Cambridge Econometrics, Ecologic, Policy Studies Institute (PSI) and King's College London (KCL).

This report, prepared by IEPP with input from Ecologic and the wider team, addresses one specific task within the wider project, i.e. Task C: on the *Feasibility of implementing a radical ETR and its acceptance*. The task covers the following aspects:

- Explore what radical approaches for ETR exist and their potential feasibility – this focuses on ‘enhanced cooperation’, and also on the use of the ‘open method of coordination’ (OMC) to allow a radical step forward on ETR.
- Explore what experts see as the need and potential for ETR - by making use of interviews and questionnaire.

The report analyses the legal feasibility and political acceptability of a radical ETR within the broader context of EU policies, exploring ways to harmonise ETR across Member States – especially through enhanced cooperation and OMC. It also investigates the potential for ETR to help tackle current and future environmental challenges, the perceived barriers to ETR and the way to overcome them.

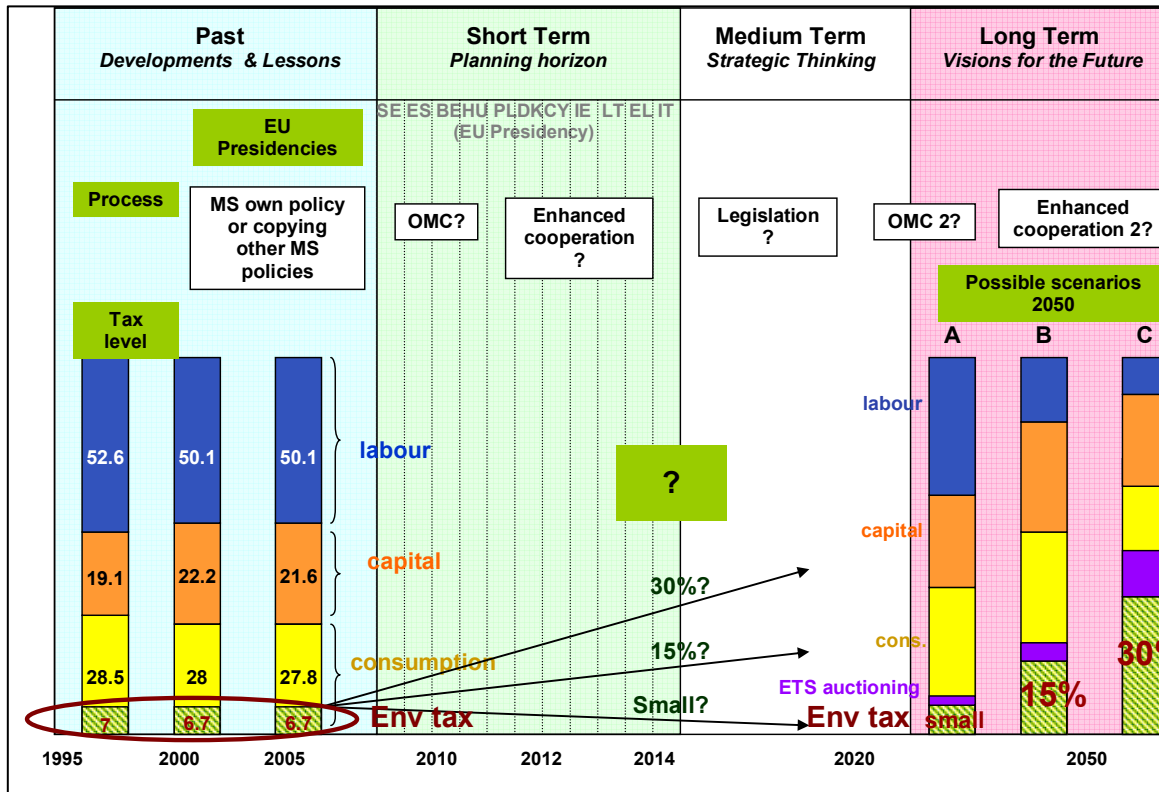
1.2 Methodology used for the analysis

The analysis is based on opinions and insights gathered through a questionnaire and interviews with representatives of different directorates of the European Commission, the European Environmental Agency (EEA), the Joint Research Centre (JRC), the Organisation for Economic Co-operation and Development (OECD), some EU Member States, NGOs and other experts. The questionnaire was sent to about 100 experts, and 31 responses were received, i.e. almost 30 percent of the people contacted provided their insights to this work. Overall 20 questionnaire responses were received and 11 interviews carried out.

The study team acknowledges the valuable contributions of the 31 respondents. Their input helped bring new ideas and insights to the debate on ETR and understand the current state of play in the EU.

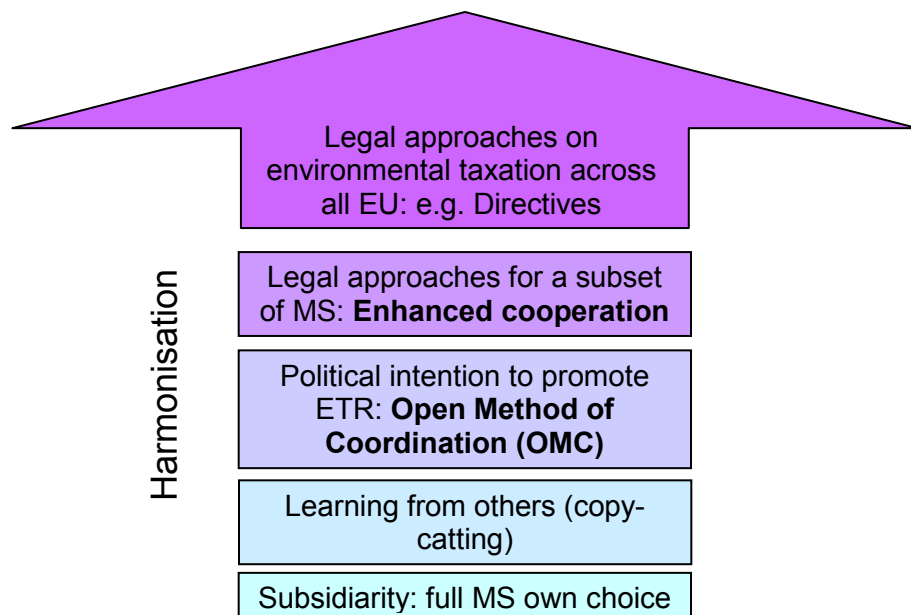
The questions to experts and institutions addressed in particular the possible future size of ETR and its contribution to improved environmental policy in the, short medium and long term – see figure 1.

Figure 1 ETR dynamic in the short to long term



The questionnaire and interviews also explored ways to achieve future developments by looking at legal and political tools to achieve it, and focussing on OMC and enhanced cooperation. The answers were complemented by an in-depth literature review and analysis of legal texts.

Figure 2 Approaches to achieve ETR – different levels of harmonisation



An overview of the key questions and areas explored in the questionnaire is provided in the box below. The full text of the questionnaire is included in Annex 1.

Box 1 Key questions raised in the questionnaire and interviews

Future policies and scenarios

- Are environmental taxes useful to help face future environmental/social/economic challenges?
- To what extent could ETR help address the challenges in: climate change, energy, biodiversity, air and water quality, resource scarcity, sustainable consumption/production, other areas?
- What increase of environmental taxes would be feasible by 2050 be feasible? What should be ideally achieved by 2020? What by 2010?
- Should environmental taxes be seen as a permanent or transient tool?
- How will the EU ETS likely affect the potential for tax reform?

Harmonisation process

- What approach should be used to achieve greater harmonisation across the EU in the field of ETR?
- Should clauses for enhanced cooperation be made more flexible?
- Who would be the MS most likely to engage on an enhanced cooperation process?

Acceptability of ETR

- Who has been historically more in favour of ETR, who less keen (including among MS, economic sectors, pressure groups)?
- How to address the fact that usually ‘losers’ mobilise more strongly against ETR, while ‘winners’ are less active in campaigning in favour of ETR?
- What can be learned from past lessons on ETR?
- What argument could help overcome barriers to ETR?
- What are the main messages that should be communicated to increase ETR societal acceptance and minimise political opposition?
- How can higher environmental taxes be justified in case of high oil prices?

Note that, as the title suggests, the work is aimed at investigating feasibility and acceptability of a ‘radical ETR’. The word ‘radical’ is here interpreted in two ways.

One is related to the level of ETR – i.e. that there is a ‘radical’ progressing of ETR, or rather a step change in its application such that it moves to what experts see as its full potential. In other word, there will be a ‘radical ETR’ if there is a substantial increase of the share of environmental taxes, partly or fully counterbalanced by a decrease in other taxes.

The other interpretation relates to the use of ‘radical’ approaches to better harmonise ETR across the EU, where radical is seen in the light of current practice. Enhanced cooperation is indeed currently seen as a radical solution. Even more radical would be the regulation of ETR through EU legislation. The use of the OMC instead is hardly radical in its current form, but if given more political support and proactive true engagement, then it too can be regarded as ‘radical’.

1.3 Structure of the report

This report is structured as follow:

The present chapter (Chapter 1) summarises the aims and objectives of the work.

Chapter 2 provides an overview on the acceptability and feasibility of ETR, investigates the state of play and the potential for increasing the share of environmental taxes and the linkages between and ETR and ETS

Chapter 3 presents insights on the social acceptability of more radical ETR

Chapter 4 investigates the issue of harmonisation and the legislative power of the European Community with respect to taxation generally and environmental taxes specifically

Chapter 5 illustrates the possibility to use enhanced cooperation in the context of ETR

Chapter 6 investigates the potential for the Open method of Coordination (OMC)

Chapter 7 explores possible pathways for ETR harmonisation comparing enhanced cooperation and the OMC.

Chapter 8 summarises key conclusions and recommendations

Annex I provides the original text of the questionnaire used to gather insights and comments on ETR.

2 FEASIBILITY OF ENVIRONMENTAL TAX REFORM IN THE EU IN THE SHORT, MEDIUM AND LONG TERM FUTURE

2.1 Introduction to Environmental Tax Reform

In a European future with an increasingly ageing population, pressing environmental problems, growing resource scarcity, and the need for increased energy security, a shift in the tax base from labour to environmentally damaging activities - i.e. an Environmental Tax Reform (ETR) - could help address both economic and environmental concerns.

Environmental tax reform (ETR)⁶ refers to ‘a gradual shift of the tax base away from taxing ‘good resources’ such as investment and labour, toward taxing ‘bad resources’ such as pollution and inefficient use of energy’ (EEA, 2005).

Such redistribution of the tax burden aims to provide appropriate signals to consumers and producers, lead to a better functioning of markets and increased welfare, and move society towards more sustainable development.

ETR is meant in principle to lead to a so called ‘*double dividend*’, i.e. an improvement in both the environment (by properly pricing externalities) and to the economy as a whole, by making the cost of labour cheaper and therefore encouraging employment.

The concept of revenue neutrality is also often associated to ETR, as additional revenues from environmental taxes can be used to decrease revenues from other taxes so that the overall tax burden remains the same. Revenue neutrality, however, is a choice, and ETR can also form part of an overall tax reduction or increase approach.

Several studies have explored the issue of ETR, suggesting that ETR can have play a significant role in achieving climate change/environmental objectives can also lead to positive or at least non negative economic effect. A summary of the key finding of some major recent works on ETR are presented in the box below.

Box 2 Overview of some recent major studies on ETR

PETRE - Productivity and Environmental Tax Reform in Europe (2007-2009)⁷. The project explored the economic, environmental and resource implications, for Europe and the rest of the world, of a large-scale ETR in Europe that could achieve the EU’s GHG reduction targets by 2020. The study produced results that suggested that energy use (and associated unabated emissions) will tend to rise with income, and that increases in energy prices will

⁶ The term ‘Ecological Tax reform’ and ‘Green tax reform’ are also frequently used. ‘Environmental Fiscal reform (EFR)’ instead refers to a broader concept that includes reform of environmentally harmful subsidies.

⁷ PETRE was a three-year project, one of four funded by the Anglo-German Foundation (AGF). It was led by the Policy Studies Institute until the end of 2007, then led by King’s College London, and involved other five project partners.

tend to reduce energy use more effectively than just regulatory strategies. ETR was indicated as a strategic use of the price mechanism to increase energy efficiency and reduce energy demand.

The findings obtained through the use of 2 macro-econometric models and 6 scenarios suggested that ETR can be effective to achieve the EU GHG reduction targets with broadly neutral or positive economic impacts, and potentially also reduce the consumption of other resources. It was estimated that the carbon prices needed to reach the EU GHG targets should be between €53-68/t CO₂ (or lower if tax revenues are invested in low carbon technologies) if the EU were to reach a 20% GHG reduction by 2020, and about €180-200/tonne CO₂ to achieve the 30% global target.

The effect on GDP was estimated to be small, while it emerged that ETR could increase employment. Overall, the research indicates that a broadly based ETR across Europe could play a very important and cost-effective role in meeting the EU's emission reduction targets for 2020, especially in a context of global cooperation on climate policy.

Source: PETRE website <http://www.petre.org.uk/> and Ekins, 2009

COMETR – Competitiveness Effects of Environmental Tax Reform (2004-2007)⁸. The project undertook an analysis of the competitiveness impacts of green tax reforms at a sectoral level, using modelling frameworks (bottom-up and macro-economic) as well as case studies concerning the existing tax reforms which have taken place in the EU and Candidate countries. The overall perspective was ex-post, i.e. models were fed with data from actual experiences.

Evidence showed that the 'double dividend' theory proved true in five EU countries applying ETR. In Sweden, Denmark, the Netherlands, Finland and Germany CO₂ and energy taxation over the last 17 years has made a small but positive contribution to economic growth of up to 0.5 per cent, while CO₂ emissions have been reduced. In UK the reform has been neutral, but here the scale of the tax rates levied has been modest and it was also the most recent ETR.

The positive contribution to economic growth arises because carbon-energy taxation leads to more efficient use of energy while at the same time wage costs are lowered. It also leads to improved competitiveness for energy-efficient businesses and for the development of new products which also can be exported. Taxation of petrol shifts demand to other products and products of a more domestic nature.

The analyses pointed to a difference in outcomes according to whether it is the energy price which is increased or the energy tax. This is due to the fact that the revenue from a tax remains in the public purse and can be used to lower other taxes. Furthermore domestic taxes do not affect the prices of imported raw materials and intermediate goods.

Source: COMETR website <http://www2.dmu.dk/cometr/> and Skou Andersen, M. 2007

PETRAS - Policies for Ecological Tax Reform: assessment of social responses (2000-2002)⁹. The project examines the responses of grassroots stakeholders to ecological tax reform (ETR) policies and proposals. The study aimed to develop proposals to improve the design of ecological tax reforms and maximise their political acceptability while still

⁸ The study is a Specific Targeted Research Project (STREP) supported by the EU's Sixth Framework Programme for Research (FP6). It was coordinated by the Department of Policy Analysis at the National Environmental Research Institute, University of Aarhus in Denmark and had 6 partners.

⁹ The project is supported by the EU's Fifth Framework Programme for Research (FP5). It was led by the University of Surrey in UK and involved other 4 partners.

attempting to meet their objectives. The project also examined the attitudes of business and the general public towards in ETR policies in five member states (France, Denmark, Germany, UK and Ireland). The methodology was based on the use of interviews and focus groups to inform the assessment of social responses to ETR policies.

The project's six specific objectives were: (1) To assess the patterns of awareness of ETR policies; (2) To gauge the understanding of the intentions behind ETR in terms of environment and employment; (3) To assess patterns of support or hostility towards specific policies and the general principles of ETR; (4) To identify specific objections to these policies and principles; (5) To assess what sort of ETR design would be regarded most favourably; and (6) To assess how far that design might compromise the effectiveness in meeting environmental, economic and employment objectives.

Source: PETRAS website <http://www.soc.surrey.ac.uk/petras/>

For simplicity in this chapter we often use the expression 'environmental taxes' to refer to taxes, charges and fees., However, it is useful to keep in mind the specific definitions of these tools, where:

- A 'tax' is '*any compulsory, unrequited payment to general government levied on tax-bases deemed to be of particular relevance. Taxes are unrequited in the sense that benefits provided by government to taxpayers are not normally in proportion to their payments*' (OECD, 2001). This implies that their amount (revenue) depend on 'political' decisions, e.g. raise revenue or change consumer behaviour, and not on the actual benefit of the good/service provided. VAT is a typical example of (indirect) tax.
- 'Charges and fees' are typically payments for a specific service. They are compulsory and requited payments to general government or to bodies outside general government, such as environmental funds or a water management boards (EEA, 2005). They are 'requited' in the sense that they are meant to cover, in part or in full, the cost of a specific service/good, for instance the cost of supplying drinking water of waste disposal. Typical examples are waste water charges, abstraction charge and waste charges.¹⁰

Some examples of common environmental taxes are provided in Box 3 below.

¹⁰ The distinction between taxes and charges is not always well established. With pollution, this distinction is rather blurred because a tax based on measured emissions can be described as a charge. (Barde and Owens, 1993)

Box 3 Environmental taxes - examples

- Air/Energy: CO₂, SO₂, NO_x, fuels
- Transport: Car sales/registration taxes, annual car circulation tax
- Water: Water effluent charges, water pollution taxes, water abstraction charges
- Waste: Landfill tax, dangerous waste
- Noise: Aviation noise
- Natural resources: Gravel, Sand, Land use charges
- Products: Tyres, Beverage containers, Packaging, Plastic bags, Batteries, Light bulbs, Fertilisers, Pesticides, Solvents

Source: based on EEA, 2006

2.2 The uptake of ETR and environmental taxes in the EU

To date, only a few Member States have adopted some forms of ETR. Finland (1990), Sweden (1991) and Denmark (1993) were the first to embrace the concept and strategy of ETR, followed by the Netherlands (1996, 2001), Germany (1999) and the United Kingdom (1996, 2001 and 2002) (EEA, 2005) – see map below. Other Member States have adopted environmental (green) taxes, but not full ETR strategies.

Figure 3 Member States currently adopting an ETR system (in green)



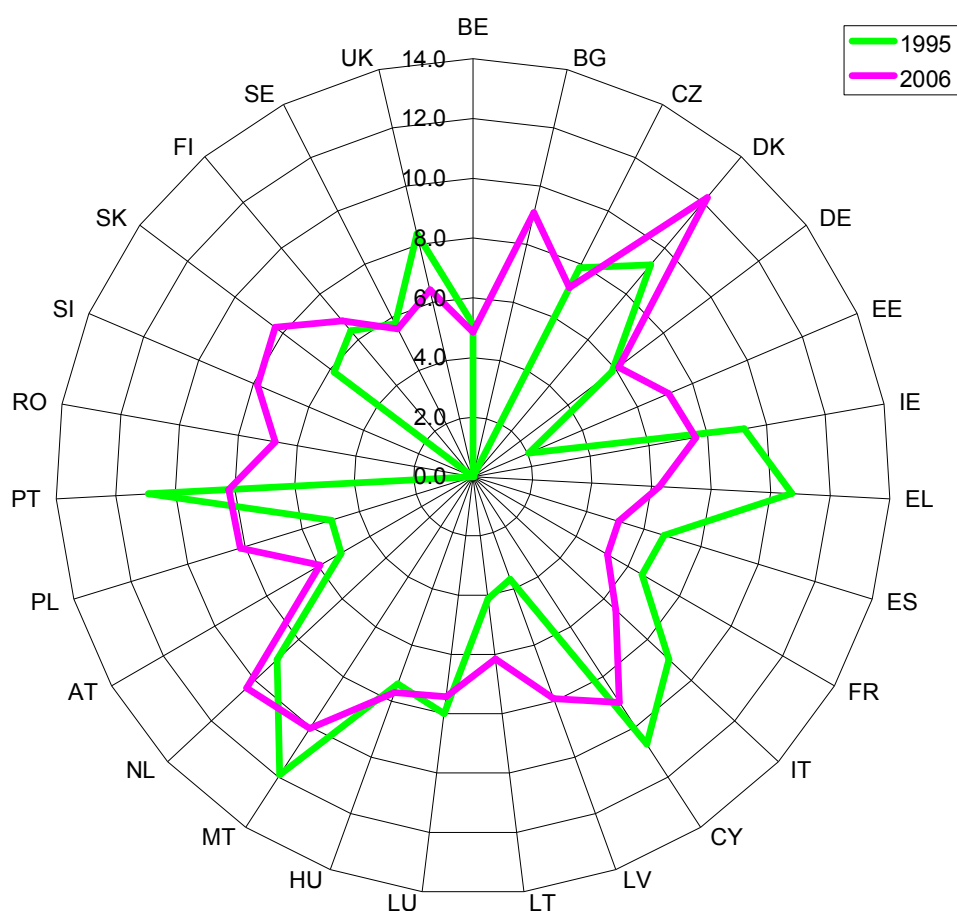
The level of uptake of environmental taxes in the EU is also uneven. Some countries such as Denmark, the Netherlands and Malta have been keener to implement green taxes, which reached a level of respectively 12.2, 10.4 and 10.1 per cent of total tax revenues in 2006. At the other extreme, France, Spain and Belgium recorded the lowest percentage of revenues from environmental taxes – respectively 5.2, 5.1 and 4.9 per cent in 2006. Furthermore, while in some countries the share of green taxes has increased in the past 10 years, in others the trend has been decreasing. (EC, 2008a)

At EU level, after a general increase in the 90s, the EU (weighted) average of environmental taxes has decreased from 1995 to 2006 from 7 to 6.4 per cent.

The figure below shows the percentage share of green taxes (over total tax revenues) in the 27 EU Member States in 1995 and in 2006.

It should be noted, however, that the share of green taxes over total tax revenues is also sensitive to changes in the amount of total taxes – i.e. a decrease in total tax revenues will result in an increase of the share, even if the amount of green taxes does not change. Therefore these percentages should be taken with care.

Figure 4 Green taxes as a percentage of total taxation in EU-27 (1995-2006)



Source: based on data from Eurostat (EC, 2008a)

2.3 Role and potential of ETR and environmental taxes

From the questionnaire responses and interviews it emerged that most of the respondents considered environmental taxes and charges an important tool to help facing current and future environmental challenges, such as climate change, resource scarcity (living within one planet's resources) and their related price increase (e.g. oil prices), increasing pollution and the need for increased energy security. Environmental taxes can help set the right price of resources and indicate scarcity, or at least offer incentives to make resource use more efficient and reduce pollution intensity.

It was also noted that, due to globalisation and the high mobility of factors such as capital, related sources of revenue have become more vulnerable and less suitable, thus favouring tax shifts towards less mobile sources such as consumption and labour. But labour as a tax base will inevitably shrink with an ageing population, thus shifting taxes further towards consumption. This, together with ambitious environmental objectives and emphasis on cost-effectiveness, can create a natural incentive for a more extensive use of environmental taxation and possibly a shift in tax revenue.

Some stressed that environmental tax reform can be a possible win-win option both for Ministries of Finance and Ministries of Environment, as it can allow the securing of a future tax base for the former and reduce the costs of policy making for the latter.

It is clear, however, that taxes are not a panacea to address all environmental problems, and limitations on their size and area of applicability exist. Some scepticism was expressed regarding the possibility that ETR could effectively address the issue of a shrinking labour tax base due to a decreasing and ageing population. Demographic changes and their implications for the tax base can be difficult to predict, as they will also depend largely on immigration policy. Furthermore, the environmental tax base is also subject to decline as environmental objectives are achieved – e.g. reduced energy and fuel use. The auctioning of ETS allowances could provide some additional revenues (see below) that could be channelled into national fiscal resources, but these may still not be enough to counterbalance possibly significant foregone revenue from a shrinking labour bases.

Most respondents regarded favourably the possibility to use revenues from green taxes to reduce other taxes, including on labour. However, some noted that rising revenues should not be the main aim of green taxes, which should rather be meant to deliver environmental improvements in an effective way.

Some believed that only earmarking the revenues to environmental activities (e.g. for technology shifts) could guarantee policy coherence and ensure environmental improvements. Some highlighted also a potential risk that a tax shift from labour to environment could lead to economic distortions which, in turn, could potentially cause additional pollution – e.g. due to increased production or consumption. It is interesting to note that, conversely, the analysis of responses to the Green paper on market based instruments (xxx) reveals that member States '*repeatedly stressed the need to bear in mind that the main objective of taxation was to generate revenue*' (EC, 2009). There are clearly some discrepancies in the expectations of different

actors, which should be taken into consideration when looking for an agreement on the way revenues should be used.

Some questioned the power of environmental taxes to change behaviour, as price is generally not the only element of purchasing decisions. Also, for medium-high incomes the effect of higher prices on consumption may be negligible. On the other hand, if they were to lead to higher food prices, taxes could be difficult to accept from a social point of view. The importance of implementing taxes as part of a broader package of instruments (including compensatory measures, information campaign etc) seems therefore imperative.

2.4 Areas of applicability of green taxes in the context of EU environmental policy

Despite the important role environmental taxes can play to achieve environmental objectives, it is clear that green taxes are not a panacea to address all environmental problems, and limitations on their size and area of applicability exist. A ‘one solution fits all’ approach should be avoided, as green taxes can be effective in some areas, but less in other.

It is useful to understand which environmental policies are more amenable to be addressed through environmental taxes, and those where other tools should be preferred. Ideally it would be useful to agree, at EU level, on a range policy areas where taxes can be implemented more effectively, providing useful guidance to Member States wishing to introduce ETR.

Also, it should be noted that while usually the revenues from environmental taxes can potentially be used to compensate for decreases in other taxes, i.e. for an ETR, the revenues from charges (e.g. water tariffs) are paid for a service and are therefore not available for recycling measures. This should be taken into account when designing ETR systems.

Table 1 below provides an overview of the insights collected from the questionnaire respondents and interviewees. For different areas of environmental policy the table clarifies, on the basis of the insights collected, whether taxation is applicable, and what are the most suitable tools to address them. Taxation tools are highlighted in bold, to distinguish them from regulatory tools and other market based instruments.

Although this is not meant to be an exhaustive list of tools, it offers a useful overview of experts’ suggestions.

For instance, most experts agreed that green taxes have significant scope to address climate change mitigation, i.e. to curb greenhouse gas (GHG) emissions from key sectors. Notably, a carbon tax could help tackle emissions from non-ETS sectors. The scope of using taxes to stimulate climate change adaptation measures is less clear, as planning and investment instruments seem more suitable. Some applications are, however, conceivable, such as land use taxation differentiated by (climate) risk zones.

Also, part of the revenues from green taxes could be channelled into a fund for climate change adaptation and mitigation.

Responses also revealed that there is a large potential for using taxes in the field of energy. Experience with energy and fuel taxes is quite solid, and well designed tools have proved effective in both reducing energy use and raising substantial revenues. The possible increase of energy/fuel market prices, however, may lower their level of acceptability. Some suggested that taxes could be used to leverage the oil price and make it more predictable. Some also looked with interest at the proposal to split energy taxes into an environmental and energy component, as suggested in the European Commission's Green Paper on Market Based Instruments. (EC, 2007).

According to some respondents, the use of mandatory standards to stimulate energy efficiency in buildings appears to be more effective than taxes. However, it can be argued that green taxes are very likely to have an effect on the use of energy in buildings.

It was noted that the uptake of renewable energy sources (RES) could be stimulated to some extent by carbon taxes and by applying higher taxes to fossil fuels. However, RES technologies that are less cost-effective may need other form of support in order to emerge as, despite the use of taxes, they may still remain too expensive compared to other fuels at least in the short- medium term.

Biodiversity conservation seems also less amenable to be addressed through taxation, while a range of other old and new tools may have larger potential - including regulation, land/urban planning, Payment for Environmental Services (PES), habitat banking and international PES for reducing Emissions from Deforestation and Forest Degradation (REDD). Nevertheless, some scope exist for stimulating the sustainable harvesting of forest products e.g. by taxing timber without Forest Stewardship Council (FSC) certificate. Also taxes on fertilisers and pesticides could in principle cover external costs and incentivise organic farming, as well as improve water quality. These, however, are likely to receive significant opposition from farmers, as their income would be affected, hence in some Member States their introduction could be difficult. Land use taxes could also be an option to incentivise more sustainable use of land, although these are relatively new tools and may result difficult to implement.

As for air and water quality, it was noted that traditionally these have been addressed through command-and-control mechanisms (e.g. emissions standards, requirements for best available techniques (BAT) as well as ambient quality standards). In the case of water quality, the Water Framework Directive (WFD)¹¹ now requires that provision and environmental and resource costs are integrated into the price of water. This will have an increasing effect as this is implemented in the

¹¹ European Commission. Directive 2000/60/EC of the European Parliament and of the Council of 23 October 2000 establishing a framework for Community action in the field of water policy. OJ L 327, 22.12.2000

coming years. As for air quality, it was observed how emission charges (e.g. SO₂ and NO_x tax) have been used successfully in some Member States.

Many respondents stressed that considerable scope exists to use taxes in the transport sector - to reduce diffuse air pollution, CO₂ emissions and energy use, as well as to address congestion. The Eurovignette directive¹², congestion charges and other road pricing schemes, parking fees and (carbon differentiated) vehicle taxes (registration and annual circulation taxes) each may offer significant potential in the coming years. Existing tax differentials in favour of diesel or petrol should arguably be removed or reduced, it was pointed out. Some highlighted need to raise fuel prices over time to address fuel security and climate considerations as well as to encourage innovation - although public acceptability will be a crucial issue for success or failure.

Many noted that taxes can potentially be effective to improve the efficiency of resource use – e.g. to counterbalance water scarcity (for instance through water pricing – as requested by the WFD) and to rationalise the use of materials such as sand, and gravel (already applied in a few Member States) and metals. For instance, findings from the PetrE project¹³ show that a tax on material inputs could generate revenues almost in the same range than the pricing of carbon. To a more limited extent taxes could be used to stimulate sustainable consumption and production – e.g. using different VAT rates to promote more environmentally friendly products or services. Product charges (e.g. batteries, electrical appliances, plastic bags) and deposit refund schemes (bottles) also have potential for widened use. The plastic bag tax for instance is already being ‘copied’ by a range of countries, following its success in Ireland.

It was also highlighted that environmental taxes have proven effective in the waste sector. Landfill taxes and waste tariffs/charges are already widely used across the EU. Some argued that some harmonisation in this area could be particularly useful to avoid ‘waste tourism’.

The responses revealed that, conversely, some issues may need a more radical change in behaviour that taxes may not guarantee, e.g. in case of immediate risk for human health and the environment. For instance some hazardous substances may require a complete phase out rather than a gradual approach through price signals – as in the case of the complete ban of chlorofluorocarbons (CFCs).

Overall, there seems to be major scope for building on the example set by leading countries – e.g. on carbon taxes, landfill taxes, pollution taxes, circulation charges, product taxes, natural resource charges. There remains scope for revising and extending existing instruments – such as the level of excise tax and landfill tax rates – by adjusting the rates and design, which may allow a simpler policy route (e.g. not requiring primary legislation in some cases). There is also scope for new instruments

¹² Directive 1999/62/EC of the European Parliament and of the Council of 17 June 1999 on the charging of heavy goods vehicles for the use of certain infrastructures OJ L 187/42 20.7. 1999

¹³ See PetrE website: <http://www.petre.org.uk/>

– like landuse taxes/charges (e.g. for conversation of land), material taxes and maritime fuel taxes. There is also potential for leverage – e.g. exploring the possibility to link structural fund allocation to the existence of green taxes. Importantly, a reform of environmental taxation should also include the removal or reform of environmentally harmful subsidies (EHS). While not the specific focus of this report, EHS reform will clearly be an invaluable part of an environmental fiscal reform.

Table 1 Environment policy areas and scope for using environmental taxes – experts’ views

Policy	Scope for taxation?	Possible tools
Climate change	<p>Mitigation: YES. Certainly scope here, although some overlapping with ETS.</p> <p>Adaptation¹⁴: LIMITED. Scope less clear, but some applications are conceivable</p>	<p><i>Mitigation (reducing emissions to avoid climate change):</i> especially through energy and fuel taxes (see below). Potential to cover small scale consumers and private households.</p> <p>ETS already regulates GHG – some overlaps, However, a carbon tax could cover non-ETS sectors.</p> <p>CO2 reductions could be also addressed in part through regulation.</p> <p>Synergies with transport measures – e.g. vehicle taxes and aviation taxes (see below)</p> <p><i>Adaptation:</i> conceivable to create specific instruments, e.g. income tax deductions for precautionary measures, land use taxation differentiated by risk zones</p> <p>Planning instruments can be more useful or complementary</p> <p><i>Both:</i> a levy on resources used (based on GNP or total waste) to feed into a superfund to mitigate and adapt to climate change</p>
Energy policy	<p>YES. Large potential here.</p> <p>However more LIMITED for RES.</p>	<p>Energy and fuel taxes are common environmental taxes. They can curb energy consumption and rise significant revenues. The possible increase of energy/fuel market prices, however, may lower the scope and acceptability of higher taxes.</p> <p>Energy taxes could be split into an environmental and an energy component, as suggested in the MBI Green Paper (Commission, 2007) and/or differentiated according to carbon content and other environmental considerations (e.g. toxicity, harmfulness for the environment).</p> <p>Taxes could be used to leverage the oil price and make it more predictable – i.e. reducing the tax rate when prices increase and vice versa, so that the price to</p>

¹⁴ However mitigation and adaptation should not be seen in isolation. For instance one should take into account that adaptation may promote mitigating options, but also require carbon-intensive production, e.g. sea walls

Policy	Scope for taxation?	Possible tools
		<p>consumers remain constant</p> <p>Nuclear energy: taxes on radioactive waste (see below) and taxes on uranium fuel</p> <p>Taxes addressing energy use in buildings and energy passports could be explored –tools should address home owners rather than tenants – i.e. who can make the actual purchase of technology/equipments</p> <p>Promoting RES through taxation has proved difficult – e.g. ECJ ruled against Finnish tax exemptions for RES – and not always effective. However, the use of pricing mechanisms (feed-in tariffs) has often been useful for their uptake.</p> <p>RES can be promoted also through carbon taxes. Also, an increase in the price of energy from fossil fuel could stimulate the market of relatively cheap RES technologies. However, less cost-effective RES technologies may need other form of support in order to emerge as, despite the use of taxes, they may still remain too expensive compared to other fuels. Other instruments can be more effective and guarantee a more stable and predictable framework for investors, e.g. feed in tariffs, incentives etc</p>
Biodiversity	<p>LIMITED. Not obvious application. Difficult to define the tax base. Also, benefits for the general public are less visible and may need strong awareness building. Regulation can be more effective</p>	<p>The sustainable harvesting of forest products could be promoted by taxing timber without an FSC certificate.</p> <p>Taxes on fertilisers and pesticides could in principle cover externalities cost and incentivise organic farming, as well as improve water quality</p> <p>Land use taxation could be an option, although difficult to implement. Exemptions could be accorded depending on the land use (e.g. for conservation land). However they will likely not be enough to achieve optimal level of conservation and will need to be combined with appropriate regulation, sustainable planning and removal of EHS.</p> <p>Other tools: habitat banking, fees and fines, PES and REDD.</p> <p>Fragmentation difficult to address with taxes, should rather be tackled by investing in green infrastructures.</p> <p>Biodiversity protection is also indirectly linked with a range of other issues, such as water stress and quality, chemicals, exploitation of gravel and sands, industrial pollution and transport - see other sections</p>
Air quality	<p>SOME.</p>	<p>Traditionally addressed through command and control.</p> <p>Tradable permits can also be appropriate</p> <p>However some taxes on pollutants have been effective without being too unpopular, such as the Swedish NOx charge.</p>

Policy	Scope for taxation?	Possible tools
		Air quality also links with transport and industrial emissions and chemicals – see other sections
Transport	YES.	<p>Good examples in the transport sector: e.g. Eurovignette, congestion charges ~ (e.g. London).</p> <p>Road pricing should also be explored further, to compensate for the cost of infrastructures. It could also be differentiated according to the area where the road is located, with higher prices where biodiversity is more at risk. However, road pricing should be explored together with fuel taxes, to avoid possible trade-offs.</p> <p>Vehicle taxes are important to influence transport mode (both sales/registration and circulation/possession taxes), e.g. taxes on vehicles without particle filter and Selective Catalytic Reduction (SCR), or tax reductions for electric cars. They should arguably be imposed (i.e. reformed as they exist everywhere) according to the use, polluting impact and the occupation of the vehicles, e.g. along the lines of the Swedish car tax.</p> <p>Petrol and diesel taxes can be useful to stimulate the uptake of electric cars and improve air quality (e.g. PM emissions are particularly high for diesel). Tax differential in favour of diesel should be avoided/reformed.</p> <p>In general, taxes can be particularly effective for freight/commercial transport as they are more reactive to price signals.</p>
Water quality	SOME. Command and control is also important	<p>Some instruments exist, e.g. in Germany (waste water and drinking water charges – see also resource scarcity below).</p> <p>The inclusion of environmental and resource cost in water pricing (see below) can help improve quality.</p> <p><i>Bathing water:</i> limited scope for economic instruments – regulation is more suited</p> <p>Water quality also links with water scarcity and chemicals – see below</p>
Resource scarcity	<p>YES. Relevant to address water scarcity (increasingly important issue) and other specific scarce resources – such as metals and gravel.</p> <p>SOME. Could also be applied to some extent to stimulate sustainable consumption and production and for</p>	<p><i>Water scarcity:</i> water tariff/charges (as requested by WFD). Rising block tariffs could optimise water consumption and spur technological improvements. Charges should be linked to individual behaviour (e.g. on the basis of individual meters) – see above</p> <p>Taxes on metals: so far very heterogeneous approaches. Relatively low revenue but can be more substantial if applied to a broad range of materials. Tax could be per mass unit or differentiated by toxicity.</p> <p>Taxes on gravel, sands and other materials extracted from rivers and quarries, in proportion to their environmental impacts and encouraging the re-use of building material</p>

Policy	Scope for taxation?	Possible tools
	land. LIMITED. Fish	<p>Scope for <i>non built-up area</i>: land use tax</p> <p>SCP: tools depend on the type of good/service. VAT differentiation (of significant amount) between environmental and non-environmental products can affect consumption. Synergies with a number of possible taxes, such as energy tax – which can stimulate the uptake of energy-efficient products; taxes on non recyclable goods; taxes addressed at emissions; waste tariffs/charges.</p> <p><i>Fish</i>: some scope to explore increased VAT for fishery – e.g. based on quantity species scarcity. Others argue that fishery should be better regulated by tradable quota.</p>
Other	<p>YES. For a range of products</p> <p>SOME. For some chemicals, but not for those that need to be banned – regulation more effective</p>	<p><i>Waste</i> – waste tariffs/charges should cover the full costs and could be linked to individual behaviour (volume/weight/quality terms), and discounts should be offered for separate collection to encourage recycling. The harmonisation of landfill taxes at EU level should be explored</p> <p><i>Hazardous waste</i>: e.g. fiscal contributions by producers /distributors of electric products and packaging to cover for cost of recovering and externalities related to waste; Taxes on nuclear radioactive waste (proportionate to radioactivity level and duration)</p> <p><i>Non recycled material</i>: e.g. Taxes on non-recycled paper.</p> <p><i>Tourism</i>: Tourism tax (in % or the value of night spent) to contribute to peak adaptation of e.g. water, waste and public transport in touristic areas</p> <p><i>Chemicals</i>. CFCs: were banned through regulation – here taxes would have been less effective. In general, regulation seems more advisable for toxic substances (setting limits, concentrations or bans). For other substances chemicals taxes could be imposed, e.g. proportionally to their environmental harmfulness</p>

2.5 ETR in context: environmental fiscal reform (EFR) and EU Emission Trading Scheme (ETS)

Importantly, taxes should not work in isolation, but need to be seen in context with other measures, including command and control, cap and trade and other market and non market instruments, which can work in parallel to achieve common goals. Taxes may also need to be coupled with remediating measures in order to ensure that due support to the most vulnerable categories is provided. Furthermore, the issue of reversing environmentally harmful subsidies and tax fraud will also be essential elements to make sure that a tax shift is effective.

In this regard, ‘**Environmental Fiscal Reform (EFR)**’ is a key concept, as it refers to a broader context that includes, beside ETR, reform of environmentally harmful subsidies. Although this chapter focuses on ETR, one should be aware of the implications of other market-based instruments (including subsidies) and their interactions with taxes when making assumptions in the long term future.

A broader fiscal reform is likely to include, beside taxes and subsidies, other economic tools that can play a significant role, not only to achieve environmental objectives but also in terms of revenue raised. This is particularly the case of the auctioning of carbon allowances in the context of the EU **Emission Trading System (ETS)**.

Taxes and **ETS** can lead to different advantages and disadvantages. In the case of ETS the focus is on the amount of emission reductions – as the cap is set by policy makers. Emission trading is often preferred by industry as it can lower the domestic effort to reduce emission as cheaper emission reductions can be brought from abroad. ETS also can offer protection to exposed energy intensive industries through the choice of allowances allocation – although, arguably, this can also imply a stronger influence of business lobbying on policy design. The price of allowances, however, is uncertain therefore carbon markets are highly volatile.

Auctioning is expected to play an increasing role and, arguably, represent a substantial source of revenue in the future. The way these revenues will be used – i.e. for domestic purposes (e.g. reduction of other taxes), or for international policies (e.g. technology transfer, adaptation) – will be a key issue, and will determine how much ETS auctioning will be able to contribute to future ETRs. This discussion is likely to become increasingly important during the coming years.

Taxes focus on prices and, broadly speaking, guarantee a more stable and predictable cost of emission abatement – as the amount of taxes is set by policy makers. They have lower transaction costs and, by providing certainty over future costs, can potentially encourage investment (including in green technologies). Furthermore, they can encourage a restructuring of domestic production patterns as, unlike ETS, it does not rely on emission reductions achieved abroad (although problems of carbon leakage may remain an issue). Taxes, however, cannot ensure that emission reductions targets will be achieved, as the amount of reductions is not known beforehand.

According to the opinions and insights collected through the questionnaire and interviews, there is a general view that **ETR and ETS can coexist and complement each other**. Rather than alternatives, they should be seen as different instruments converging to the same aim. It was argued that any instrument that generates revenue that is freely available to the public budget allows, in principle, for environmental tax reform. That is also why, in the recent years, discussions about environmental instruments and possible environmental tax reforms have referred to market-based instruments, instead of just taxes.

Respondents pointed out that, for instance, carbon taxes could be used to cover non-ETS sectors, with ETS covering the main industrial sectors and carbon taxes addressing small business and private households. Also, taxes could help bridge some of the gaps/weaknesses of ETS, such as the non-inclusion of other GHG gases, the inefficient distribution of emission rights, or the imperfect connection among EU markets and with other world markets. Taxes could also be used as a ‘safety valve’ when the price of permits becomes too high.

Some further suggest that, in the future (e.g. after 2020) upstream ETS could be introduced, which would cover energy consumption in all sectors. Others argued instead that, if the ETS systems would become too complex or lead to erratic prices, taxes could be preferable. The issue of price fluctuations, however, could become less problematic in the future, once the market will become more stable, more participants are involved and trading periods become longer. Current proposals to introduce lower and upper limits for carbon prices could also reduce the differences with ecotaxes in terms of price stability.

In terms of revenues from ETR, for the period after 2013, the Commission has estimated in its impact assessment (EC, 2008b) that under full auctioning, revenue from ETS could generate annually revenue up to 0.5 per cent of GDP. The Ministries of Finance have already had the opportunity to take a position on the issue by stressing that revenue should be freely available to the public budget and should not be earmarked for environmental purposes (cf. the statement of the ECOFIN Council 12/2/2008 (Council of the European Union, 2008)).

In terms of the **allocation of revenues from auctioning**, many options seem possible. Auctioning revenues could contribute to reduce the amount of distortionary taxes – such as labour taxes. Alternatively, this function could be left to ecotaxes, while revenues from auctioning could be used to finance adaptation and mitigation in developing countries, including in the context of reducing global emissions in the Copenhagen process. Others instead believed that revenues should be used within the EU. Whatever the use, the significance of the ETS contribution to revenue raising will depend clearly on the amount of allowances auctioned. Currently this is expected to be relatively low in the short run, hence revenues are likely to be quite negligible over the next five years, but in principle the share of auctioning is expected to increase more substantially in the future. In this regard, some respondents suggested that ambitious targets for auctioning carbon credits should be set, and were confident that in the long term ETS will move to full auctioning with a more stable carbon price. Others, however, were more sceptical of the use of auctioning, and feared that their interaction with taxes could be distortionary. It was also pointed the suitability of revenue from emission trading for tax reform purposes may be reduced by the fact that ETS typically generates less reliable revenue stream due to greater volatility in the levels of revenue (linked to volatility in the price of allowances). Furthermore, the revenue from emission trading is more prone to earmarking.

Although the future of auctioning is so far still uncertain, it is clear that ETR should be seen as part of a wider package, together with ETS and other measures, to contribute to the internalisation of externalities and the application of the ‘Polluter Pays Principle’, and avoid or reduce possible carbon leakage. ETR can be seen as

covering the whole set of associated instruments – such as taxes, charges, subsidies, and tradable permits.

2.6 The future of ETR in the short, medium and long term

In a recent report by the Green New Deal Group (2008) it is highlighted that the global economy is facing a ‘triple crunch’; a financial crisis, accelerating climate change and increasing (or surely unstable) energy prices. In order to overcome the crisis, the report calls for ‘*a sustained programme to invest in and deploy energy conservation and renewable energies, coupled with effective demand management*’ together with ‘*a structural transformation of the regulation of national and international financial systems, and major changes to taxation systems*’.

In light of the recent debate on a ‘green new deal’ and the opportunities to link environmental measures to a recovery of the EU economic and fiscal system, a gradual introduction ETR could be seen as a move in the right direction, with some new environmental taxes introduced in the near future and a more radical shift from labour to environmental taxes in the long run.

As noted above, so far the use of environmental taxes witnessed an increase in the 1990s, but reached a plateau in the past 10 years and stabilised at around 7 percent of total tax revenues, and their distribution is very uneven across Member States. It is difficult to predict what the future share of environmental taxes over total fiscal revenues will be in the EU, and what would be a level acceptable to Member States. One could expect the level of revenues from environmental taxes to remain more or less the same as today – i.e. around 7 per cent - or to double in the medium term, or to reach more ambitious levels in the long term.

Different development paths for environmental taxes can be hypothesised. Figure 5 below shows three simple scenarios, which were drafted to explore expert views regarding green taxes increases in the long run. A long time horizon was used (2050) to help ‘unlock’ expert views from focus on current political constraints. The three simple scenarios proposed were:

- A) *Minor changes*: A reduced income from labour due to demographic/social changes is compensated by some additional capital and consumption taxes; there is a slight increase of environmental taxes but not substantial
- B) *Doubling of environmental taxes*: Significantly reduced income from labour are mainly compensated by environmental taxes and other consumption taxes. Increase of environmental taxes (and auction receipts) up to 15 per cent of total revenues – i.e. about a doubling of the current level
- C) *Extreme case – very significant increase of environmental taxes*: labour taxes are almost completely substituted by capital and consumption taxes. Environmental taxes provide for up to 30 per cent of revenues or more

It is important to take into account, when discussing increases in the share of environmental taxes, that these can also be affected by the definition of environmental

taxes used (e.g. the widely-used Eurostat/TAXUD indicators include genuine tax revenues, thus excluding for example revenue raised by road user charges or revenue from auctioning of ETS allowances), and also by the share of other taxes in total tax revenue - the lower the share of other taxes in total revenue (e.g. due to recession), the higher the share of environmental taxes (which might be less open to cyclical changes).

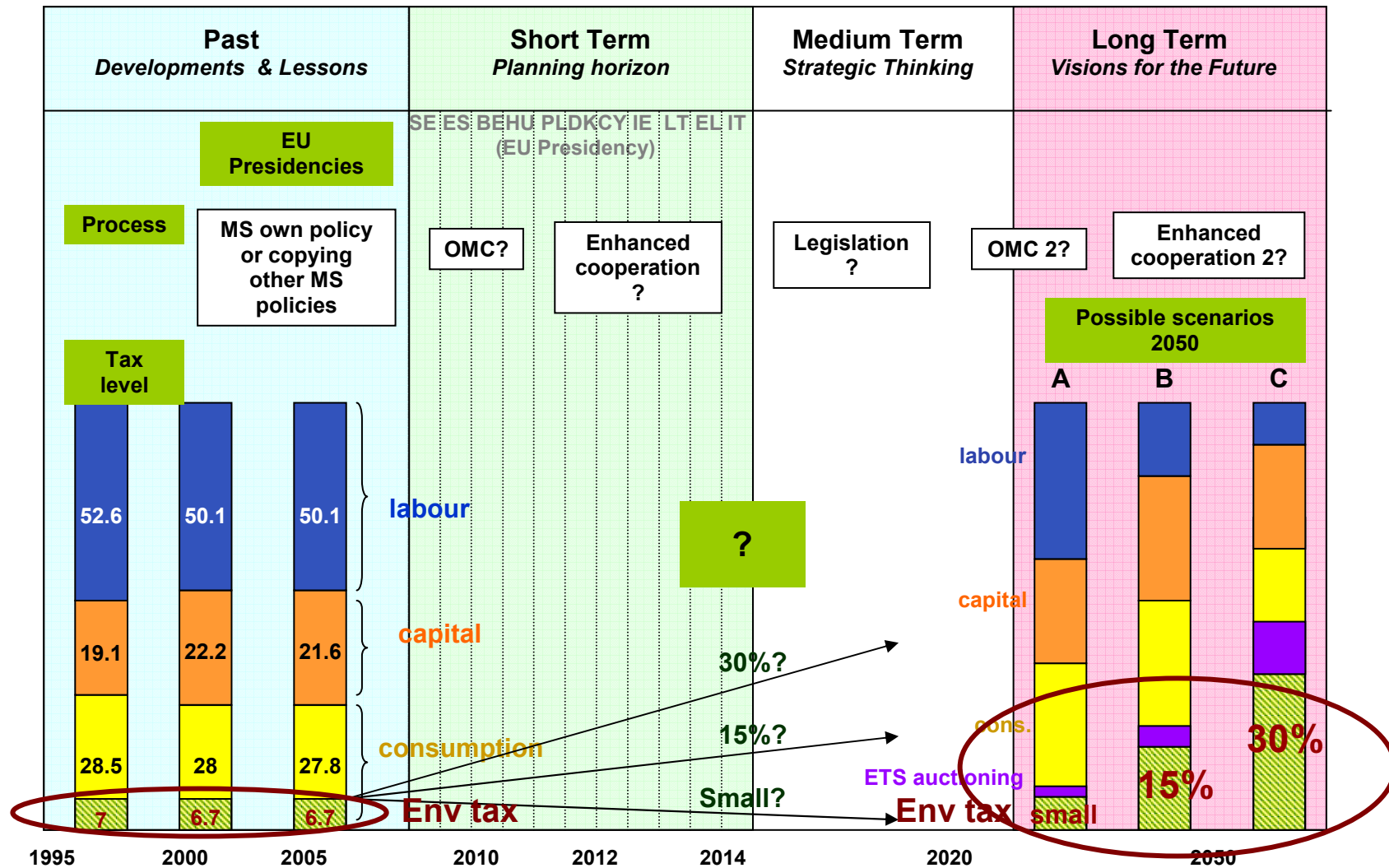
As for the scenarios developed for this study, it should be noted that the percentages used are not based on actual modelling but are meant to represent rough changes, i.e. no change, a doubling of green taxes shares and an ambitious scenario where green taxes are up to one third of total revenues. These scenarios aimed to stimulate a 'qualitative' response, and were not meant to represent mathematical estimations.

Furthermore, it should be noted that the share of environmental taxes in overall tax revenue depends on several issues, in particular on:

- The share of other taxes in total tax revenue: (the lower the share of other taxes in total revenue (e.g. due to recession), the higher the share of environmental taxes.
- The definitions used: the widely-used Eurostat/Taxud indicators include genuine tax revenues, thus excluding for example revenue raised by road user charges (revenue hypothecated on the transport sector) or revenue from auctioning of ETS allowances.
- The policy justification: given that environmental taxes largely need policy justification, numerical targets alone do not make much sense if they are not underpinned by real needs and externalities in the environmental area. Moreover, increasing use of other environmental instruments (such as environmentally-related road charging or emission trading) either reduces the maximum potential share of environmental taxes in total tax revenues or requires that revenue from the alternative instruments is also included in the figure (see also chapter 2.5 above for a discussion on the role of ETR and the broader implications of environmental fiscal reforms)

Interestingly, however, a doubling of environmental taxes (up to 15 per cent of total revenues) is consistent with modelling simulation done under the PetrE study. The results of the project shows that a doubling of the environmental tax revenues in 2020 - including revenues generated via the auctioning of emission allowances – as a result of a large-scale ETR in Europe can be achieved with rather negligible effects on GDP growth but with an increase in employment (see also Ekins and Speck, 2009).

Figure 5 ETR dynamic in the short, medium and long term¹⁵



¹⁵ European Commission. 2008. *Taxation trends in the European Union. Data for the EU Member States and Norway*. Eurostat Statistical Books

In the questionnaire and in the course of interviews, respondents provided their insights as to the likeliness of these scenarios, and on the scope for ETR to help address current and future environmental challenges. Ideas and suggestions were collected on the possible path of development in the tax shift at EU level in the short (next 5 years), medium (by 2020) and long run (2050). Key insights are summarised below.

In general, **a doubling of the relative share of green taxes** was considered feasible and desirable by most of questionnaire respondents and interviewees.

In the short run steep increase of environmental taxes, however, is likely to be difficult to achieve in many Member States due to political opposition. Nevertheless, a number of measures could be introduced to stimulate a gradual shift towards ETR. Experts suggested that, for instance, the dissemination of examples and good practices from Member States which have already implemented ETR will be a good starting point for those countries which are less advanced in the use of environmental taxes. Building public and business awareness by advertising economic, social and environmental benefits of ETR will also be beneficial.

As for policy priorities, some respondents considered the development of energy taxation a priority, given the urgency of climate change issues. In the upcoming revision of the Energy Taxation Directive some suggested that the EU minimum levels of energy taxation should be increased and aircraft kerosene should be included (although this should be seen in the context of the inclusion of aviation in ETS). It was noted that it will be interesting to explore possibilities to link the agreement on the EU budget 2014-17 to the agreement on the revised Directive.

Furthermore, it was suggested that the auctioning of ETS permits should be increased, while an equivalent tax for the sectors opting-out should be introduced. In this regard, it will be useful to establish a clear ‘work sharing’ between ETS and environmental taxes, and possibly explore links between the ETS and the Energy Taxation Directives.

Reducing the spread between green taxes in EU Member States was also considered crucial in order to prevent unwanted competitiveness effects.

With regard to other policy areas, an EU legislation on minimum water extraction charges was seen as potentially beneficial to stimulate water savings through taxation.

The revision of the EU SDS could also offer the opportunity to strengthen the message on ETR.

In the context of a wider EFR, the removal of environmentally harmful subsidies was seen as a priority.

In the medium and long term, the majority agreed that a doubling of the share of environmental taxes (i.e. 14-15 per cent) by 2050 would be realistic and advisable. Some believed that a higher share could be achieved already in 2020 (e.g. 17 per cent), and argue that further increase should be explored (e.g. a further doubling by

2050). This will also depend on the ambition of environmental objectives that will need to be fulfilled at national and EU level, especially on climate change. Some, however, argued that the share of environmental taxes may not increase substantially, e.g. no more than 10 per cent including revenues from auctioning. Others noted that the level of taxes should be geared to demand elasticities (e.g. for energy) and adapted to long term objectives. A further suggestion was to tax production factors (including labour) in proportion to their contributions to GDP.

For both short and long term, it was suggested to introduce a 1 per cent GDP shift from labour/capital taxes to environment/resources taxation every year from 2010 on in each EU country, in order to encourage Member States to agree common measures. Others suggested to anchor EU Structural and Cohesion Funds to green taxes objectives, e.g. granting access to funds only if a certain share of environmental taxes is introduced, and using funds to reward good environmental behaviour.

Many pointed out that, whatever the share increase, the introduction of additional environmental taxes should be done through a stepwise approach and over a pre-determined and pre-announced schedule. This will be important for the stability of the system and will provide a consistent signal for technical innovation and investments.

Some noted that there are arguments for replacing (part of) labour taxes not only by consumption taxes (including environmental taxes), but also by increased capital taxes. This, however, may be difficult and will depend on the level of international competition and on the international legal framework.

In general the **tax revenue from environmental taxes and charges is expected to shrink over time** once their environmental objectives are achieved. Some therefore see environmental taxes as a temporary measure which will gradually disappear once its objectives are met. For instance, with an increased use of renewable energy sources, the revenues for taxes or charges on fossil fuels will decrease. However, it was noted, even in such a case energy taxes would still be needed to achieve various policy objectives, i.e. tax as a means to stabilise energy prices or as a price incentive to encourage energy efficiency. These objectives make sense even for clean energies, since all energy is scarce and needs to be consumed as efficiently as possible. It is, however, open to discussion what such taxes on clean energy shall be called.

Furthermore, many respondents considered green taxes a permanent tool as demand for many taxed goods is relatively inelastic and tax rates are not high enough to make fundamental differences in most cases for the short and medium term. They can, however, be used to steer behaviour and respond to new societal and environmental needs. The tax rates can be adjusted (or new ones imposed) when more ambitious policy targets are set, unpredicted environmental problems arise, or windows of opportunity emerge. An interesting example of permanent source of revenues for instance is the tax on plastic bags. In Ireland the tax led to a substantial reduction of plastic bags. Nevertheless a large number is still sold, and the tax rate has increased so that the tax still brings substantial revenues.

The issue of the shrinking of the tax base is surely an important one, especially in the long run. While this could be seen as a positive sign, i.e. if the tax bases being reduced

as environmental objectives are met (e.g. reduced CO₂ emission and energy consumption), it also raises the issue of a gradual shrinking of tax revenues, and therefore reduced scope for revenue shifts through ETR. This is a complex issue and depends on to what extent current targets will be met, how ambitious future targets will need to be and, in general, how the economy and the environment will look like in the future. Although this falls outside the scope of this study, it is worthwhile mentioning that this issue may deserve to be explored in further detail whenever investigating the long term effect of ETR.

More broadly, it was noted that a ‘radical environmental tax reform’ should not be an objective in itself. A radical shift should follow from ‘radical environmental policy’ which, while in some countries may exist already, in others will need to be introduced or substantially developed. In principle, there has never been more suitable opportunity to do this than the present. Improving the environment by using market-based instruments and undertaking a tax reform could facilitate economic recovery, secure tax revenue and help to move the economy in the right direction. On the other hand, aspects such as ageing population (which allows for a shift in tax revenue, but not in the tax burden) or a wider use of non-tax instruments for environmental purposes might make such move more difficult. In general, a ‘radical environmental tax reform’ would require ambitious objectives that can justify an environment-related tax base, an environment-related revenue stream available to the government (which will require close co-operation between Ministries of Environment and Finance), and the commitment to use such revenue to reform the tax structure and public finance.

3 SOCIAL ACCEPTABILITY OF ENVIRONMENTAL TAX REFORM

3.1 Benefits of ETR, perceived barriers and the issue of social acceptability

Many benefits have been attributed to ETR – not only from an environmental point of view (e.g. addressing diffuse source of pollution and tackling natural resources overuse), but also from a social perspective (improving health, equality, and employment) and economic perspective (e.g. leading to resource saving and stimulating technology).

ETR can help **internalise externalities** providing the right market signals, stimulate **eco-innovation** and energy/resource use **efficiency**. Also, through **revenue raising**, ETR may have the potential to respond to the expected decline of European population (leading to a decrease in the labour tax base) by shifting part of the tax burden from the shrinking working population onto the expanding and long living population of lifetime consumers.

It can potentially enhance **transparency** of the fiscal system, reducing the scope for tax evasion, and reinforce **compliance** with environmental regulations. In terms of **welfare**, ETR can grant citizens the freedom to influence the amount of taxes they pay through their consumption habits. ETR can also remove costs unfairly born by some groups in society, e.g. children, elderly, poorer people, improving social **equality**. The use of environmental taxes can also increase **environmental awareness** among citizens and tax payers.

Nevertheless, it is clear that several barriers and criticism to ETR implementation still exist, such as the fear of an **increase in the cost of production** (despite cheaper labour cost), negative impacts on international **competitiveness**, potential effects on **inflation**, perceived **impacts to low income groups**, a potential **shrinking and unreliable tax base** (eroded by the achievement of environmental objectives that taxes aim to stimulate). Some also argue that, the cost of pollution often being unknown, it is impossible to identify an optimum tax level. In some cases, simply **political caution** near elections or the fear lobbying from strong economic sectors made governments reluctant to implement ETR.

Several examples and good practices have proved how the perception of some of these obstacles is in some places wrong, or showed the way to overcome them. These include a **careful design** of ETR, **gradual introduction** of measures (including early announcement), extensive **consultations**, **information** (e.g. on best practices) and **awareness raising**, improved **understanding** of externalities and economic/environmental implications, development of environmental taxes as part of **policy packages**, **removal of perverse subsidies**, introduction of temporary **exemptions** and careful **evaluation** of measures.

However, there is still a general lack of confidence in a possible future shift towards more radical ETR in the short term, as currently the uptake of environmental taxes has still been relatively small. There is also a general lack of vision as to what a more

appropriate tax structure could be in the absence of political pressure and vested interests.

A number of insights and suggestions regarding the barriers to ETR and the way they could be overcome were provided in the questionnaire and interviews responses.

Some pointed out that there has been traditionally a substantial **lack of knowledge** among the business sector and the general public about what ETR is and its implications. The level of awareness varies across Member States. Recent studies for instance showed that the level of understanding of ETR in the Czech Republic is very low (Vojáček and Klusák, 2007). Making sure the involved stakeholders are informed and aware of the benefits of ETR will be crucial to engage them in the reform process and increase acceptability. Importantly, the advantages for the environment and employment should be highlighted. The results of cost-benefit analysis and the quantification of externalities should be made clear and understandable.

How effective the **European Commission** can be in helping disseminating ideas and awareness on ETR depends on national contexts, including on the level of euroscepticism of Member States. It was noted that the Commission engaged on substantial awareness campaigns when a carbon tax was meant to be introduced in the 1990s, but it turned out not to be particularly successful, especially in countries such as the UK, which are traditionally more eurosceptical.

Demonstrating the existence and effects of **externalities** will be an important element of communication. This in principle does not imply that taxes have to be set a level equal to externality costs, but rather be set at a level effective to change behaviour. The identification of costs and benefits of a tax, however, should be clearly portrayed to justify the implementation of ETR.

Consultation can be very useful, but the topic can be very technical, and the level of public awareness may be insufficient to tackle detailed design issues. It was noted that in the past debates have tended to focus too much on instruments, while what matters would be rather to reach agreement on environmental objectives and the introduction of ETR in a broad sense (see also the case of France in Box 6 below)

Distributional issues are also frequently associated with ETR, especially when high taxes can lead to higher fuel prices. It was suggested that undesired distributional effects of environmental taxes could be addressed at various levels, e.g. transferring more money to poor households, independently of the environmental policy context, or providing targeted support for poor households, e.g. to allow for energy-saving investments. In the short run, transitional compensation measures for high energy prices may be necessary for vulnerable population groups, since most energy-saving measures cannot be brought into effect immediately. It was further noted that ETR in itself could make environmental policies and instruments more publicly acceptable, as it allows Governments to compensate to those social groups who would face higher costs due to the policy. ETR therefore could be seen as a means to diminish, rather than increase, adverse distributional consequences of a policy.

It is difficult, however, to identify specific solutions for distributional issues, as these are typically related to national/local conditions. In the UK and Ireland for instance there is a specific problem related to ‘**fuel poverty**’. In the UK, equity concerns made the introduction of higher household’s energy taxes almost impossible. Surprisingly, however, in a country like Sweden, which has a rather equitable social structure and where typically equity problems are given high attention, it was possible to introduce relatively high energy taxes on households. It was noted that energy efficiency of households in the UK is much lower than in Nordic countries, and this may have a higher impact on poor households when energy prices are increased, as energy savings may be difficult to achieve. Improving energy efficiency in countries like the UK therefore appears crucial if energy prices are to be increased through an ETR. In general, it was pointed out that a very good social security net would be required to deal with the regressive aspects of taxes on heating. The absence of this might make the taxation of household heating impossible.

The problem of **higher fuel prices** induced by taxes, typically linked to the issue of equity and distribution, is also frequently mentioned by ETR opponents. It was noted, however, that recent (exogenous) oil price increases have been more disruptive in the US, where fuel taxes are lower than in the EU. Similarly, oil prices hikes had the strongest impacts on sheltered sectors, such as aviation, shipping and fishing. This is because a sudden increase of prices is more noticeable when prices are low, i.e. the *share* of the increase (over total price) is higher. Environmental taxes in addition can potentially be used to improve energy efficiency, and therefore reduce dependence on imported oil. Some also argued that environmental taxes could be used to stabilise oil prices, i.e. taxes could be raised when prices are low and increased when there are high, maintaining the overall price to consumer stable. It was noted however that, although this may be possible in a single country, it may not work for a block of countries, as this will send signals to oil producers to maintain the prices high.

In order to increase social acceptance, e.g. of making car transport more expensive, more emphasis could be put on demonstrating that **environmental stress is unevenly distributed** in the society (e.g. poor population groups suffer most from air pollution). However, this should not be turned into an argument against the necessity of alleviating regressive effects on the taxation side, which will remain important.

The issue of **competitiveness** could be addressed with a careful design of ETR, including associating taxes with other forms of incentives, so that sectors are not penalised internationally and rather innovation is stimulated. The use of **border tax adjustments** and/or **international agreement** was often mentioned as a possible way to mitigate competitiveness issues.

Many noted that the **expression ‘tax’ is often criticised** as it is associated with a negative meaning of increased fiscal burden. The expression ‘environmental tax reform’ and ‘environmental taxes’ hence can be difficult to market to tax payers.

It was also noted that, at an **international/global level**, as long as the EU remains largely isolated in its environmental efforts (to the extent that they increase costs for business), green taxes risk shifting capital outside the EU, in the same way as capital

taxes. However with changes in attitude towards environmental protection around the globe, such a disadvantage might easily disappear.

Useful insights were also given into the type of **messages** that should be communicated to increase ETR acceptability.

It is often argued that it is usually ‘**losers**’ that mobilise against ETR, while ‘**winner**s’ are less aware of the benefits and therefore less active in campaigning in favour of ETR. This is a common problem in policy making, and does not affect only environmental policy. ETR, however, clearly has its own categories of winners and losers. Some economic lobbies have been particularly opposed to the introduction of ETR and could potentially hamper the development of ETR in the future. Among the economic sectors, it is clear that the energy-intensive ones have been most opposed (e.g. chemistry, aluminium manufacturing, but also greenhouse farming), as well as other big users of natural resources (e.g. companies extracting mineral resources) and, in general, the most polluting activities, i.e. those that are more directly affected by price increases related to the internalisation of the environmental costs that were beforehand borne by society.

The fact that losers ‘speak more strongly’ than winners often depends on the fact that the costs of the policy are more visible than its benefits. It is important therefore to **assess and highlight the benefits of ETR and also emphasise the costs of policy inaction**. Revenue recycling can be used, importantly, to diminish welfare costs of environmental taxation (as a result of the environmental policy put in place) and compensate those social groups hit the hardest by cost increases. In this sense, ETR is a useful and recommendable policy and the Member States should be made aware of its benefits. This is also in accordance with the conclusions of the Communication on European values in the globalised world, Contribution of the Commission to the October Meeting of Heads of State and Government, which suggest a shift of the tax burden from labour to consumption and/or pollution taxes as a part of the strategy to increase employment (EC, 2005).

A strong environmental justification can potentially weaken the ability of ‘losers’ to block efforts. Most respondents indeed stressed that the **importance of a strong information campaign**. This will also help emphasize the importance and the benefits of a tax shift even when these are not evident. As tax systems are typically in evolution in fact, an increase in environmental taxes accompanied by a decrease in labour charges might be ‘spoiled’ later on by new increases in labour charges as a result of social policy developments. Providing the right policy justification and explaining these dynamics will be important to gain consensus in such cases. It will also be important to ‘reassure’ stakeholders on the way the issue of income distribution and competitiveness will be addressed since, as noted above, these have always been typical arguments against ETR. Some noted that further information and a justification of ETR at EU level (e.g. by the European Commission) could help overcome local/national political reluctance to run against national lobbies. The introduction of positive measures offsetting some of the negative impacts on the most affected sectors (e.g. a decline on income taxation) can also be useful to win some resistance. An example of public perception in the UK is also presented in Box 4 below.

Box 4 Public opinion on green tax shifts

A number of UK public opinion polls about green taxes showed that these were opposed by a substantial majority of people. Such polls however usually presented the taxes as additional, rather than part of a tax shift with higher green taxes offset by a lowering of other taxes.

A recent poll by the Green Fiscal Commission found that there were large majorities in favour of a green tax a shift. Most respondents were in favour of shifts of taxes to aviation, motoring and household energy offset with reductions in other taxes.

Further consultations revealed that there was conditional public support for green fiscal reform. On the one hand, there was approval for the principles of green taxation and recognition that fiscal mechanisms were effective at changing behaviour. On the other, the public was concerned about the fairness of environmental taxes in certain instances.

If a programme of green fiscal reform is to be taken forward there is therefore a need to motivate people about the importance of climate change, to overcome scepticism that other taxes would be reduced, to effectively communicate the financial implications for households, and for institutions to facilitate the transition to low-carbon lifestyles.

Source: Based on Green Fiscal Commission, 2009a

It was noted that the right messages will depend on the **political and social context of a country**. Opposition may be historically higher in some countries, lower in others.

The (positive) effect of a tax shift for instance can be particularly relevant in countries with **high labour taxes**, where ETR could be seen as a useful tool to alleviate fiscal pressure on labour. There is a clear opportunity here to clearly communicate these benefits in order to improve acceptability.

A key issue in the past has been that **many did not perceive or believe that environmental tax increases would have been offset by decreases in other taxes**, hence it was frequently opposed as it was perceived as a net increase of the tax burden. The current situation is in a way more favourable, as tax increases in some countries are now considered unavoidable in order to counterbalance the fiscal deficit caused by the recent economic crisis. The general public may hence perceive that, **if some taxes have to increase, it is better if they address environmental objectives**. This is for instance seen as an attractive argument in the UK, and also possibly in other countries. The acceptability of ETR, however, should not be taken for granted. Some may for instance simply attribute the tax increases to green taxes, leading to a negative view on environmental tools.

Some general criticisms of ETR and the arguments against them are presented in Box 5 below.

Box 5 Opponent's claims and counter arguments on the German ETR

ETR was introduced in Germany in 1999. An analysis of its effects after its first phase, which ended in 2003, has been undertaken by Green Budget Germany. The analysis showed that, over that period, the total volume of energy taxes rose from €24.1 to €52.7 billion – i.e. an

increase of 55 per cent. Over the same period, pension contributions have been cut by 0.8 per cent.

A summary of some of the key opponents' claims and counter arguments based on actual developments of the German ETR are presented below:

'Ecotaxes are just an excuse to raise tax ratios and public spending'. Not true. Despite a 55 percent increase in energy taxes, the overall tax ratio fell by more than four percent between 1999 and 2003.

'A successful ecotax would soon exhaust itself, because the tax base is eroded'. Not true so far. High energy taxes lead to a reduction in energy consumption. A genuine 'erosion' of energy consumption has not been reached yet, hence the basis has not been reduced dramatically. On balance, tax revenues increase, because taxes increase at a higher rate than the basic volume is reduced by.

'Ecotaxes cost jobs'. Not true. The reduction in ancillary wage costs, the innovative impact and the easing of pressure on the manufacturing industry and services mean that existing jobs are protected and additional ones are created. It was anticipated that up to 250,000 new jobs would result from the ecological tax reform by 2003.

'Ecotaxes do not do anything for the environment'. Not true. Fuel consumption has fallen for four years in succession, whilst over the same period the use of public transport has increased. CO₂ emissions have been cut by between six and seven percent. The demand for fuel-conserving cars and equipment has risen and part of the ecological tax reform revenues has also been used to promote renewable energies under the market incentive programme.

'Ecotaxes disadvantage German industry in international competition'. Not true. The manufacturing industry overall has cut its tax bill by almost one billion Euros (net). Compared with the regular tax rate, the manufacturing industry has benefited from a tax break of around 4.8 billion Euros per annum. The incentive effect for developing energy-saving vehicles and equipment also helps German industry to gain an innovative lead in exports.

Source: Based on Green Budget Germany, 2007

3.2 Lessons learned from past experiences

A number of interesting insights and examples reported by the respondents and found in the literature portray a range of lessons that could be learned from past and existing experiences of ETR.

An important lesson from the failure of introducing an EU carbon tax is that the decisive factor for preferring trading over taxation at EU level has been the **requirement for unanimity in taxation matters**, whereas ETS could be introduced by majority vote. This strengthens the argument for finding an alternative tool, either OMC, enhanced cooperation or other legislative/policy measures, to move around the limits of the unanimity rule, which as a matter of fact hampers the development of a more ambitious and harmonised use of ETR.

Furthermore, it was noted that in some cases ETS was easier to ‘sell’ when the policy did not include **the word ‘tax’** – e.g. this proved to be the case in the US, and in the 2008 election in Canada. In Europe, there is a common perception that ETS is a European-level instrument, while taxes have to be set at national level. Therefore, the terminology and presentation used to introduce ETR at more harmonised EU level is important – as the decision to implement ETR is, finally, highly political.

The **current set of economic and political circumstances** can be both positive and negative for ETR. Carbon emissions are falling as a result of the economic downturn, although a recovery could be expected to raise levels again. On the other hand fossil-fuel prices are low and credit is difficult to obtain or expensive, lowering the incentive to invest in more energy efficient technologies. However, it is widely accepted that governments need to stimulate investment markets and promote economic recovery. This could be directed towards low-carbon technologies, and at the same time ETR could be introduced to protect government revenues (a stick and carrot approach).

Information about public and business opinions is crucial to win possible resistance to ETR (see, for instance, the example of France in Box 6). The introduction of ETR clearly can have some drawbacks, which policy makers should be aware of in order to address citizens’ and businesses’ concerns. For instance, public opinion can be affected by past negative experiences with environmental taxes, especially when revenue raising instruments have been disguised as environmental instruments. Such experiences can alienate citizens from the use of tax instruments associated with environmental goals. This danger is already real in some countries with significant use of environmentally-related taxes.

Box 6 French ETR and the lack of information on public opinion

ETR was implemented in France from 1999. It aimed simplify a set of existing green taxes and implement some new ones. The additional revenues were meant to fund labour tax reduction. 75 per cent of such revenues were meant to be generated by an energy tax, which was expected to be implemented in 2001.

The energy tax was treated separately from the ETR debate and appeared as an additional project for industrial taxation rather than part of an overall ETR strategy. There was no debate on the necessity for a carbon or energy tax.

A two-year consultation process resulted in a grossly compromised tax design which exempted households, was generous to energy-intensive industries, was considered technocratic and unconstitutional and was poor economically and environmentally. The design of the tax remained controversial between the Ministry of Finance and the Ministry of Environment, especially with regard to the tax basis and the recycling of revenues. The disagreement, added to the lack of transparency which characterised the negotiation process between the government and the business representatives, led to the final decision of the Constitutional Court to terminate the energy tax project in December 2000.

Insights gleaned from focus groups and interviews indicated that the failure of the energy tax project was mainly due to the fact that decision makers lacked information about public and business opinions, and to the conflicts between the relevant ministries.

The sectors which would have borne the highest cost, i.e. energy intensive industries, were the

best informed, and exerted a strong lobbying power. On the contrary, the companies which could have benefited from the reform were not well-informed. Overall, awareness of ETR was almost non-existent, there was a general hostility to economic instruments and a common perception that regulation was the only fair policy. This highlighted the need for better public debate procedures in the taxation field.

Source: Deroubaix and Lévêque, 2006

Furthermore, one important lesson (e.g. from Germany) is that **social (distributional) aspects** need to be taken more seriously, both in the design of an ETR and in related communication. For instance, the intensive exemptions for industry have been detrimental to the credibility of ETR because they provoked the feeling that ETR design was influenced by the interests of powerful pressure groups to a considerable extent. In addition, it will be important to compensate low income groups, and make such compensations visible, in order to win over potential hostility from the general public.

Stressing the benefits of the tax shift from labour to environment will be important. It should also be made clear that the ETRs implemented so far have not led to major economic problems. In addition, the environmental improvements from ETR should be made explicit. The Obama Administration, for example, clearly set out to spend ETS revenues on efficiency, renewable energy and other environmental objectives. When benefits are not sufficiently emphasized the level of acceptability can be very low and eventually lead to the failure of a policy – see for instance the case of the UK fuel duty escalator in Box 7.

Box 7 The overlooked benefits of the UK green tax shifts

Two unannounced green tax shifts took place in the UK in the 1990s, one by a Conservative government and the other by a Labour government. In both shifts, a fuel duty escalator (FDE) increased the price of road fuels, whilst simultaneous cuts in income tax reduced the cost of labour. These initiatives were additional to the two ‘explicit’ UK tax shifts (the 1996 landfill tax and the Climate Change levy in 2001), but, although they had a similar effect (i.e. a tax shift), they were not publicised as such.

The FDEs resulted in benefits that have often been overlooked. Notably, they raised significant revenues and allowed other distorting taxes to be reduced. For instance, when the FDE was in place, income taxes were reduced from 25 to 22 per cent, the cut being more than offset by the revenues from the fuel escalator. Environmental benefits included reductions in fuel use, emissions and vehicle mileage. A reduction in taxes on labour may have increased both UK employment and economic output.

Yet these broader benefits of the tax shift went almost entirely unnoticed and uncelebrated. Public attention focused almost exclusively on the impact of the escalator on the price of fuel, the consequent impact on the consumer and business finances, and the fuel protests of 2000 that followed. Eventually, the public unpopularity of the fuel tax escalator eventually resulted in its being abandoned.

It is not clear why the two UK governments did not make an explicit connection between the FDE and the cuts in income tax which it enabled. Whether an explicit environmental and economic justification from government for the FDE would have prevented its being publicly discredited is debatable. Failing to defend it as a desirable public policy measure has caused

problems for the subsequent debate on environmental tax reform.

One important lesson is that any green tax shift therefore needs to be clearly articulated by government, highlighting both the taxes that will be increased and, more importantly, the ones that will be cut. The broader environmental and economic benefits of the shift also need to be clearly communicated to make it clear that people and businesses that pollute will pay more taxes and those who do not will pay less.

Source: Based on Green Fiscal Commission, 2009b

One should, however, be aware that public opinion in different countries may have different views and preferences regarding **environmental objectives and the way revenues are spent**. For instance, in Germany it is usually considered preferable to reinvest green taxes revenues in labour (i.e. the standard concept of tax shift as in ETR), while in other countries, like Denmark and the Netherlands, there is the perception that revenues should be used for environmental purposes – e.g. reinvested in technology or R&D.

Another lesson is that both the general public do not like taxes unless the country has a great civic sense or its citizens feels particularly involved in a common cause. For instance, in Italy the target to become a member of the European single currency was seen as and sold by the media as a common cause, and extra taxes were accepted. The way a tax reform is sold therefore has to be carefully taken into consideration, and possibly a **sense of engagement** should be created.

Transparency in the schemes designed to recycle tax revenue is another important factor. In some cases these have not been clearly and sufficiently portrayed, therefore only the increase in environmental tax rates was perceived. This may be partially due to the fact that tax decreases are much smaller in relative terms (e.g. compared to overall share of labour taxes). Furthermore, reductions are sometimes counterbalanced by tax increases due to other policy decisions. This was for instance the case for the German pension contributions and UK employers' social security contributions. In the UK, after introduction of the Climate Change Levy (CCL), where tax revenue was hypothecated to the National Insurance Contributions (NIC), there was a NIC rise. Thus CCL therefore was perceived by business as being a revenue-raising instrument. Similarly, the landfill tax was introduced during a period of falling NIC. Few employers saw any link between the tax and the National Insurance offsets in either case. This indicates a particular communication challenge in recycling revenue through NIC, as the NIC levels are varied for other reasons (ACBE, 2003). It is important therefore to make sure communication enables improved transparency, including through adequate reporting and widely disseminating easily understood information.

Predictability attracts investors. For instance the German waste water charge adopted 1976 held at a zero level until 1980. The major investments were made in the first five 'zero charge' years, in order to 'be prepared' to the announced charge. It was also noted that ETR could be introduced more successfully if it were to be made administratively simple and if rate increases were truly small (in the vicinity of 3 per cent increases per year) but fixed for a very long time. The disadvantage of this 'mild' but long term scheme, however, is that the revenues from ETR will be quite small so

that not much can be ‘bought’ from it in terms of reducing indirect labour cost, at least in the short term.

It will be important that the reform is planned as a **package** of different taxes and other measures (such as the removal of harmful subsidies and the introduction of ‘beneficial’ ones) in order to maximize its impact. The rise of environmental taxes and fees should be done gradually in order to not damage competitiveness and provide predictability for businesses and investors.

4 THE LEGISLATIVE POWER OF THE EUROPEAN COMMUNITY WITH RESPECT TO TAXATION GENERALLY AND ENVIRONMENTAL TAXES SPECIFICALLY

4.1 The issue of harmonisation

As noted above, only a few EU countries have set up ETR strategies, though many Member States have implemented environmental taxes, but not a full ETR. A common shared approach to ETR therefore has never been developed at EU level so far.

Taxes are mainly set nationally or sub-nationally and the harmonisation of taxation rules at EU level is subject to the unanimity rule. As a consequence, few developments have been achieved to increase the level of harmonisation of green taxes and ETR.

Undertaking a more radical ETR (i.e. with a larger share of green taxes) at national level is frequently said to be hard in the context of competition within the internal market and globally. The way forward to date has rather been one of cautious introduction of a new tax by one country, with other countries then ‘following the example’. There has been some step-by-step progress, with some *de facto* harmonisation as followers adopted other member states’ approaches. Overall development, however, has been relatively slow.

The questionnaire responses revealed a mild to strong interest in achieving greater harmonisation at EU level in the field of ETR. Some, however argued that it is not evident that harmonisation in this field would be either needed or desirable, and stressed that harmonisation of environmental taxes would be particularly sensitive.

It is clear that the perception of the benefits of increased harmonisation is not uniform, and that concerns exist over the possibility to overrule Member States’ competence to use tax revenues and structure their tax system.

The issue of harmonising environmental taxes is clearly highly debatable, and falls outside the scope of this study. The present work therefore rather aims to investigate possible tools to increase harmonisation on ETR approaches, i.e. those instruments that can stimulate a more ambitious application of tax shifts and ensure that good practices are shared and, if possible, adopted more broadly.

Different instruments are available to this end, from formal legislation (e.g. on environmental taxation) to different forms of collaboration between Member States, and these can clearly face different levels of support (or opposition). Some key approaches are summarised in the table below and described in more detail in the following sections – exploring the legal and political feasibility of achieving further harmonisation on ETR. The focus will be in particular on the legal feasibility of enhanced cooperation and the political feasibility of the open method of coordination (OMC).

Table 2 Approaches to achieve ETR at EU level

Level of harmonisation	Approaches and examples for environmental tax reform	
	Approach	Example
Tight harmonisation for a subset of EU Member States	Legal approaches and not all EU – special legal framework outside EU legal framework	Schengen process in its initial form, involving a limited number of Member States under a classical international treaty distinct from the EU treaties.
	Legal approaches and not all EU – within existing legal framework	Schengen process as incorporated into the EU legal framework, but with opt-outs for individual Member States; EMU, with individual Member States enjoying derogations from participation in the single currency Enhanced cooperation under the treaty on European Union (TEU) or Treaty establishing the European Community (TEC) – never applied in practice so far
Increased harmonisation across the EU ↑ Partial harmonisation across the EU ↑	Legal approaches (e.g. on environmental taxation, resource pricing) implemented across all EU	Legislative specific <u>minimum</u> requirement: energy tax directive, VAT
		Legislative <u>general</u> requirement: 'principle of recovery of the costs of water services' under WFD ¹⁶ for water pricing
	Political intention to promote fiscal reform: Flexible approach	Legislative <u>possibility</u>: Eurovignette
		Formal/ structured Open Method of Coordination (OMC) e.g. Lisbon Strategy, Broad Economic Policy Guidelines (including vague ETR recommendations)
		More flexible/ light OMC – e.g. <i>Green public procurement (GPP)</i>
		'Encouragement of voluntary policy coordination / towards OMC e.g. <i>Cars and CO2: encouraging national fiscal approaches; reform of environmental harmful subsidies</i>
No harmonisation	Subsidiarity / full own choice but 'learning from others'	Compare and respond to other Member States' initiatives – e.g. use of revenue neutrality
	Subsidiarity / full own choice	Own needs and own initiatives – e.g. UK Landfill tax with ETR approach

¹⁶ Unanimity was not required for WFD because this was under Art 175(1)

4.2 The power of the European Community with respect to taxation

Under Article 93 of the Treaty establishing the European Community (TEC), the Council has the power to ‘adopt provisions for the *harmonisation of legislation concerning (...) indirect taxation* to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market’. However, any such provisions can only be adopted by the **Council acting unanimously** on a proposal from the Commission. The co-decision procedure does not apply; the European Parliament is merely to be consulted. Article 95(2) TEC explicitly provides that the wide-ranging powers granted to the institutions by Article 95(1), enabling them to adopt by means of the co-decision procedure any ‘measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market’ do not apply to fiscal provisions. Similarly, the broad legislative powers vested in the institutions for the purpose of achieving the objectives of environmental policy laid down in Article 174(1) TEC are subject to restrictions when it comes to ‘provisions primarily of a fiscal nature’. By way of derogation from the co-decision procedure which applies to environmental policy measures as a general rule under Article 175(1), the Council must act unanimously under Article 175(2) if it wishes to adopt measures of a fiscal nature to pursue environmental policy objectives.

Consequently, while the EC institutions do not lack the competence to take measures to harmonise national legislation on indirect taxation when such measures are deemed necessary for the proper functioning of the internal market, or even to adopt any ‘provisions primarily of a fiscal nature’ which are deemed necessary to achieve one of the objectives of environmental policy set out in Article 174(1) TEC, in both cases the exercise of this legislative power requires unanimity within the Council. This explains why very few Community measures aimed at ETR have effectively been adopted so far, notwithstanding the declaration made by the Member States in the Final Act of the Nice Intergovernmental Conference (IGC), which provides that ‘[f]ull use should be made of all possibilities offered by the Treaty with a view to pursuing this objective [of the EU playing a leading role in promoting environmental protection], including the use of incentives and instruments which are market-oriented and intended to promote sustainable development.’

The ETR measures adopted under the EC Treaty to date are few and far between. In order to assess the feasibility of using the ‘enhanced cooperation’ provisions of the Treaties to overcome the obstacle of unanimity, it is necessary first to devote some attention to the evolution of the EU policy debate on market-based instruments generally and environmental taxation specifically, and to analyse the relevant practice of the institutions so far.

4.3 The experience with environmental taxes and other market-based instruments in EU policy and legislation

Since Maastricht, there has been considerable political debate about the instruments of EU environmental policy. Under the motto of ‘a deepening and broadening of the

range of instruments to complement normative legislation',¹⁷ the political emphasis of the **5th Environmental Action Programme (EAP)** (1992-2000)¹⁸ and its 1998 'mid-term' review Decision¹⁹ was clearly on other instruments than traditional 'command-and-control' regulation. The Council resolution approving the 5th EAP listed new instruments to be used 'including, where appropriate, market-based and other economic instruments'.²⁰ A full article of the 1998 Decision was devoted to this theme.²¹ One of the priorities was described as 'encouraging the use of fiscal instruments to achieve environmental objectives, *inter alia* by *considering possible legislative initiatives in this area* during the course of the Programme and continuing the study of the potential wider benefits of such instruments'.²² As this provision recognises, it is hard to see how the Community could effectively promote the use of fiscal instruments in environmental policy otherwise than through legislative action under either Article 93 or Article 175(2) TEC.

But the fate of the concrete legislative initiatives taken by the Commission since the 5th EAP to introduce economic instruments at EC level, as well as other language in Article 3 of Decision 2179/98/EC stressing the importance of the subsidiarity principle and of the development of economic instruments 'at the *appropriate* level',²³ indicate that Member State resistance to such initiatives is still strong. The Commission's flagship ETR initiative of the 1990s, the famous **proposal for a directive introducing a tax on carbon dioxide emissions and energy**²⁴ – which, in retrospect, only served to build the Community's image as a frontrunner in global climate change negotiations – was buried in the Council and eventually withdrawn. Even the far less ambitious proposal for a directive restructuring the Community framework for the taxation of energy products²⁵ was effectively deadlocked in

¹⁷ Resolution of the Council and the Representatives of the Governments of the Member States, meeting within the Council of 1 February 1993 on a Community programme of policy and action in relation to the environment and sustainable development, OJ C 138, 17.5.1993, p. 1.

¹⁸ *Towards Sustainability: A European Community Programme of Policy and Action in relation to the Environment and Sustainable Development*, EC Doc. COM(92) 23 final, 27 March 1992, vol. II.

¹⁹ Decision No 2179/98/EC of the European Parliament and the Council of 24 September 1998 on the review of the European Community programme of policy and action in relation to the environment and sustainable development 'Towards sustainability', OJ No L 275, 10.10.1998, p. 1 (hereafter referred to as Decision 2179/98/EC).

²⁰ Resolution of 1 February 1993, *supra* n. 1.

²¹ Decision 2179/98/EC, *supra* n. 3, art. 3, paras. 1-2.

²² *Ibid.*, para. 1(g) (emphasis added)

²³ *Ibid.*, art. 3, para. 1 (emphasis added)

²⁴ Doc. COM(92) 226 final, OJ No. C196, p. 35

²⁵ Doc. COM(97) 30 final, 12 March 1997

Council for several years, before being finally adopted in strongly watered-down form in 2003.²⁶

A Commission **staff working document prepared in support of the 2007 Green Paper on market-based instruments for environment and related policy purposes** barely contains any references to Community-wide ETR measures other than the 2003 energy taxation directive. In addition to discussing this directive and possible future measures on energy taxation building on it, it merely provides an overview of selected national measures in individual Member States, plus a section entitled ‘Scope for the use of market-based instruments under various Community directives on environmental policy’.²⁷ The latter discusses relevant provisions of three directives adopted since 2000: the **Water Framework Directive** (2000),²⁸ the **revised Packaging Waste Directive** (2004)²⁹ and the **revised Batteries Directive** (2006).³⁰ While all three contain a rather vaguely worded provision on market-based instruments, these provisions are of a purely enabling character and provide a legal framework primarily for the essentially optional application by Member States of user charges or fees or extended producer responsibility funding schemes, rather than for green tax measures. Only the revised Batteries Directive actually uses the term ‘tax’ where it provides that ‘Member States may use economic instruments to promote the collection of waste batteries and accumulators or to promote the use of batteries and accumulators containing less polluting substances, *for instance by adopting differential tax rates.*’³¹

Therefore, although economic instruments have often been mentioned in Commission and Council policy documents and in the above mentioned legislative acts, no substantial commitment has been made to the effective development of indirect, market-based forms of regulation at Community level, at least until the Commission decided to propose the use of tradable emission rights as the centrepiece of EU climate change policy in October 2001. But the **Emission Trading Scheme (ETS) Directive**, adopted in October 2003,³² is not an example of ETR. On the contrary, it

²⁶ Council Directive 2003/96/EC of 27 October 2003 restructuring the Community framework for the taxation of energy products and electricity, OJ L 283, 31.10.2003, p. 51.

²⁷ Commission Staff Working Document accompanying the Green Paper on market-based instruments for environment and related policy purposes, Doc. SEC(2007) 388, p. 21.

²⁸ Directive 2000/60/EC of 23 October 2000 establishing a framework for Community action in the field of water policy

²⁹ Directive 2004/12/EC of 11 February 2004 amending Directive 94/62/EC on packaging and packaging waste

³⁰ Directive 2006/66/EC of 6 September 2006 on batteries and accumulators and waste batteries and accumulators

³¹ *Ibid.*, art. 9 (emphasis added).

³² Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC, OJ L 275, 25.10.2003, p. 32

reflects a conscious political choice to abandon attempts at ambitious ETR at Community level by replacing a carbon/energy tax with a cap-and-trade system applying to large point sources of CO₂ in certain sectors of economic activity only.

It is certainly no coincidence that, while no real progress on ETR as an instrument of *Community* environmental policy was being made under the 5th EAP, the Commission did however manage to issue a **communication on ‘Environmental Taxes and Charges in the Single Market’**³³ which mainly highlighted ‘some potential conflicts’³⁴ between the use of fiscal instruments in environmental policy *at Member State level* and internal market policy, and ‘underline[d] the importance of the legal framework related to the functioning of the single market which has to be respected by Member States when introducing environmental taxes and charges.’³⁵

In this context, it is important to draw attention to the relevant Treaty provisions which may limit the ability of Member States to introduce environmental taxes and implement ETR policies at the national level. **Article 90 TEC** prohibits the imposition by any Member State ‘directly or indirectly, on the products of other Member States [of] *any internal taxation of any kind in excess of that imposed directly or indirectly on similar domestic products*’ as well as the imposition ‘on the products of other Member States [of] *any internal taxation of such a nature as to afford indirect protection to other products*’. While environmental taxes are normally imposed in a non-discriminatory way on domestic and imported products alike, it is important to stress that what matters for the purpose of Article 90 is effect, not intent. Economic actors from other Member States whose products are taxed on environmental grounds will very often complain that such taxation has the effect of disadvantaging them or affording indirect protection to competing domestic products. Thus, the introduction of eco-taxes on a range of products in Belgium in 1993 led to a flurry of complaints to the Commission and litigation before domestic courts and, eventually, the ECJ, based on allegations of *de facto* tax discrimination. More recently, in July 2007 the Commission sent a reasoned opinion to Hungary requesting changes in its legislation on environmental charges applicable to beverage containers. The Commission alleged that Hungary's system leads to *de facto* discrimination against products from other Member States.

The paradox of ETR in the EU is that, while the ability of Member States to carry out ETR measures is constrained by the rules of the internal market, at the same time, according to **Article 98 TEC**, Member States have an obligation to ‘conduct their economic policies with a view to contributing to the achievement of the objectives of the Community, as defined in Article 2’ of Treaty. Those objectives include the sustainable development of economic activities and the achievement of a high level of protection and enhancement of the environment.

³³ Doc. COM(97) 9 final, OJ No. C224, 23.7.1997, p. 6

³⁴ *Ibid.*, para. 51.

³⁵ *Ibid.*, para. 52.

More specifically, Member States' economic policies are to be conducted 'in the context of the broad guidelines referred to in **Article 99(2)**'. The latter clause provides that the Council shall adopt a recommendation setting out the 'broad guidelines of the economic policies of the Member States', acting by a qualified majority on a recommendation from the Commission and on the basis of a conclusion of the European Council. In 2001, the Stockholm European Council asked the Commission and Council to integrate the promotion of sustainable development into these **Broad Economic Policy Guidelines (BEPG)**. The BEPG adopted in 2001 contained a section entitled 'Enhance environmental sustainability' which stated:

'Member States should make increased use of market-based instruments in pursuit of environmental objectives, as they are often the most efficient means to curb pollution since they lead to the internalisation of external costs in prices. (...) *Gradual but steady and credible changes in the level and structure of tax rates until external costs are fully reflected in prices would minimise structural adjustment problems and support adaptation and innovative solutions by firms. This approach would also minimise the need for exemptions for those firms or sectors that are most affected. (...) Establishing a framework for the use of market-based instruments at Community level could help avoid such distortions and underpin the internal market.*'

In particular, the 2001 BEPG provided that 'it is necessary to (...) introduce and strengthen market-based policies *like taxation*, user and polluter charges, (...) reduce sectoral subsidies *and tax exemptions* and other measures which have a negative environmental impact (...) [and] agree on an appropriate framework for energy taxation at the European level.'

Soon after the adoption of the 2001 BEPG, the European Parliament and Council also adopted the **6th EAP**, which, like the 5th EAP, calls for the use of 'a blend of instruments, including market based and economic instruments'.³⁶ Actions envisaged to achieve this objective include *inter alia* 'promoting and encouraging the use of fiscal measures such as environmentally related taxes and incentives, at the appropriate national or Community level'.³⁷

The desire to promote the use of economic instruments has been reconfirmed in several policy documents that have appeared since the adoption of the 6th EAP. For example, the **Council Recommendation on the 'Integrated guidelines for growth and jobs (2005-2008)'**, replacing the 2001 BEPG and adopted on the occasion of the relaunch of the Lisbon Strategy, calls upon Member States to 'promote the development of means of internalisation of external environmental costs', *inter alia* through 'the use of market-based instruments'.³⁸ Guideline No. 14 seeks to

³⁶ Decision No 1600/2002/EC of the European Parliament and of the Council of 22 July 2002 laying down the Sixth Community Environment Action Programme, OJ L 242, 10.9.2002, p. 1, art. 3(4).

³⁷ *Ibid.*, art. 3(4), 3rd indent.

³⁸ Council Recommendation 2005/601/EC of 12 July 2005 on the broad guidelines for the economic policies of the Member States and the Community (2005 to 2008), OJ L 205, 6.8.2005, p. 28, Guideline No 11.

‘encourage the sustainable use of resources and strengthen the synergies between environmental protection and growth’, among others through ‘[t]he use of market-based instruments, so that prices better reflect environmental damage and social costs’. In particular, ‘Member States should give priority to the internalisation of external environmental costs; to increasing energy efficiency and to the development and application of environment-friendly technologies (...) through the use of market-based instruments (...) and the removal of environmentally harmful subsidies alongside other policy instruments.’

Similarly, in the '**renewed** EU Sustainable Development Strategy (SDS)' it adopted in June 2006, the European Council stated: ‘The most appropriate economic instruments should be used to promote market transparency and prices that reflect the real economic, social and environmental costs of products and services (getting prices right).’³⁹ It is to be noted that neither the 2005 Integrated Guidelines nor the 2006 SDS expressly refer to green taxes, but only in general terms to market-based instruments.

In practice, progress in the development of EU-wide ETR measures has remained excruciatingly slow. In 2003, **Directive 2003/96/EC on the taxation of energy products and electricity**,⁴⁰ proposed by the Commission in 1997 following the rejection of its 1992 carbon/energy tax proposal, was finally adopted at about the same time as the ETS Directive. It specifies minimum tax levels for motor fuels, heating fuels (oil products, natural gas and coal) and electricity. However, it also provides for a large number of exemptions, postponements and special arrangements for specific fuels, activities and Member States. Many of them were temporary in nature and expired by the end of 2006. The Directive also enables Member States to apply reduced rates or exemptions to renewable energy sources.

A 2007 **Commission Green Paper on market-based instruments**⁴¹ puts forward the option of splitting the minimum levels of energy taxation, which would mean (1) a uniform minimum rate for all fuels according to their energy content and (2) a differentiated component reflecting the environmental aspects.

In March 2007, the Commission actually presented a **proposal**⁴² to amend **Directive 2003/96/EC** in order to gradually increase the minimum tax rate for diesel, reaching the same level as petrol by 2012. According to the Commission, the proposal will (among other things) provide better environmental protection by reducing the phenomenon of 'fuel tourism' in the haulage sector and foster a decrease in motor fuel consumption in Europe. However, two years following its submission, the Council has not taken any action on this proposal. An earlier attempt to harmonize diesel tax

³⁹ EU Council Doc. 10917/06, p. 24

⁴⁰ Council Directive 2003/96/EC of 27 October 2003 restructuring the Community framework for the taxation of energy products and electricity, OJ L 283, 31.10.2003, p. 51

⁴¹ COM(2007)140

⁴² COM(2007)52

rates, launched by the Commission in 2002, also failed to get the required unanimous support from the Council. Further policy developments in the area of energy taxation may result from the comprehensive review of Directive 2003/96/EC which the Commission was originally supposed to complete in 2008, whose forthcoming adoption by the Council was subsequently announced for 2009, but which is again delayed due to disagreement within the outgoing Commission.

In 2005, the Commission proposed legislation that would require Member States levying car registration taxes and /or circulation taxes to relate at least 50% of the tax to the level of a vehicle's CO₂ emissions by 2010.⁴³ The European Parliament expressed its support for the proposal in September 2006, but asked for a broadening of the tax base to include fuel consumption and emissions of air pollutants as well. However, the Council has not considered the proposal at all since it was submitted by the Commission in July 2005.

In 2003, the Commission proposed amendments⁴⁴ to the 1999 '**Eurovignette**' Directive on road charging for lorries.⁴⁵ This proposal failed to incorporate an ETR component as it did not include the possibility for Member States to take external (environmental) costs into account in determining road use charges. However, as a result of negotiations with Council and Parliament, agreement was eventually reached on a compromise package in March 2006. The '**Eurovignette**' Directive as amended by Directive 2006/38/EC⁴⁶ now allows user charging to take into account not just infrastructure costs but also congestion and environmental issues (according to vehicle emissions category) for vehicles above 12 tonnes and above 3.5 tonnes from 2012. Member States are free to choose how to implement the system and what levels to impose. However, under current law there is no *obligation* to have charges. The Commission was asked to develop 'a generally applicable, transparent and comprehensible model for assessing the external costs of transport, such as pollution and congestion, to serve as the basis for calculating infrastructure user charges' and propose a strategy for the stepwise internalisation of external costs by mid-2008.⁴⁷ Based on this exercise, it proposed a further amendment of the '**Eurovignette**' Directive in July 2008.⁴⁸

⁴³ Proposal for a Council Directive on passenger car related taxes, COM(2005)261 final

⁴⁴ COM(2003)448

⁴⁵ Directive 1999/62/EC of the European Parliament and of the Council of 17 June 1999 on the charging of heavy goods vehicles for the use of certain infrastructures, OJ L 187, 20.7.1999, p. 42

⁴⁶ Directive 2006/38/EC of the European Parliament and of the Council of 17 May 2006 amending Directive 1999/62/EC on the charging of heavy goods vehicles for the use of certain infrastructures, OJ L 157, 9.6.2006, p. 8

⁴⁷ Directive 1999/62/EC, as amended by Directive 2006/38/EC, art. 11.

⁴⁸ Proposal for a Directive of the European Parliament and of the Council amending Directive 1999/62/EC on the charging of heavy goods vehicles for the use of certain infrastructures, COM(2008)436 final/2.

An overview of the ETR-related legislative initiatives adopted by the EU between 1992 and 2008 is presented in the table below.

Table 3 ETR-related legislative initiatives at EU level (1992-2008)

Commission proposal	Title	Legal basis (*)	Outcome
COM(92) 226	Proposal for a Directive introducing a tax on carbon dioxide emissions and energy	Article 93 TEC Article 175 TEC	Withdrawn in 2004
COM(96) 331	Proposal for a Directive on the charging of heavy goods vehicles for the use of certain infrastructures	Article 93 TEC Article 71 TEC	Directive 1999/62/EC (Eurovignette)
COM(97) 30	Proposal for a Directive restructuring the Community framework for the taxation of energy products	Article 93 EC	Directive 2003/96/EC (Energy Products Directive)
COM(2003) 448	Proposal for a Directive amending Directive 1999/62/EC on the charging of heavy goods vehicles for the use of certain infrastructures	Article 71 TEC	Directive 2006/38/EC (revised Eurovignette)
COM(2005) 261	Proposal for a Directive on passenger car related taxes	Article 93 TEC	No action by the Council
COM(2007) 52	Proposal for a Council Directive amending Directive 2003/96/EC as regards the adjustment of special tax arrangements for gas oil used as motor fuel	Article 93 TEC	No action by the Council
COM(2008) 436	Proposal for a Directive amending Directive 1999/62/EC on the charging of heavy goods vehicles for the use of certain infrastructures	Article 71 TEC	Under consideration by Council

() References are to the EC Treaty articles as currently numbered. The legal basis referred to is as stated in the preamble of the adopted legislative act, if any, or, if the proposal did not lead to adoption of a legislative act, to the legal basis as initially proposed by the Commission.*

5 LEGAL FEASIBILITY OF COMMUNITY ACTION ON ETR: ENHANCED COOPERATION

Enhanced Cooperation in a nutshell

Enhanced cooperation allows those Member States that wish to work more closely together on certain matters to do so, while respecting the single institutional framework of the Union. The countries concerned can use the enhanced cooperation procedure to move forward without the participation of all Member States where common action under the regular provisions of the Treaty is not possible. Its principles are laid down in the Treaty on European Union (art 40-45)⁴⁹ and there are detailed procedures for its application in the EC Treaty (art. 11-11a).

At least eight countries must be involved to initiate enhanced cooperation, but it remains open to any Member State that wishes to participate to join later. Enhanced cooperation must also further the Treaty objectives and respect the whole of the *acquis* Communautaire and the rights and obligations of non-participating Member States. It should not undermine the internal market or apply to an area that falls within the exclusive competence of the Community.

It can be undertaken only as a last resort, when it has been established within the Council that the objectives of such cooperation cannot be attained within a reasonable period by applying the relevant provisions of the Treaties. The Member States that wish to undertake enhanced cooperation must obtain prior authorisation from the Council, acting by a qualified majority. The Council can act only on a Commission proposal, so the applicant countries must request the Commission to submit a proposal, but cannot compel it to do so.

Examples: the provisions on enhanced cooperation have not been used until now. However, similar forms of closer cooperation between subgroups of Member States have already been applied in some areas such as the Schengen process and the set up of the EURO zone⁵⁰.

5.1 Enhanced cooperation under the EC Treaty as last amended by the Treaty of Nice

The current Treaty provisions on ‘enhanced cooperation’ are the result of a long-running political debate on the need for flexibility and differentiation in the process of European integration. As the powers of the institutions expanded as a consequence of successive Treaty changes, and the Union gradually enlarged from a small core group of six founding Member States to the current 27, the debate on enlargement versus deepening became ever more important. Even before the introduction of specific

⁴⁹ Consolidated version of the Treaty on European Union. Official Journal C 115 of 9 May 2008 – See <http://eur-lex.europa.eu/JOHtml.do?uri=OJ:C:2008:115:SOM:EN:HTML>

⁵⁰ Enhanced cooperation: *From theory to practice* (p. 97-119), in EPC, Egmont & CEPS: The Treaty of Lisbon: Implementing the Institutional Innovations; November 2007

provisions in the Treaties to allow a group of Member States to decide on joint measures going beyond the common rules applying to all was considered in the 1996 Intergovernmental Conference (IGC), which resulted in the adoption of the Treaty of Amsterdam, practices of ‘enhanced cooperation’ *avant la lettre* had already emerged in certain areas.

The first example was that of the early **Schengen Agreement** concluded between the Benelux countries, France and Germany in 1985 with a view to abolishing border controls between them. This originated as a form of intergovernmental cooperation outside the institutional and legal framework of the Community, but was subsequently incorporated into that framework by the Treaty of Amsterdam. When the economic and monetary union was established by the Treaty of Maastricht signed in February 1992 (formally called the Treaty on European Union (TEU)), the relevant provisions were explicitly based on the assumption that not all Member States would join the single currency. A special category of ‘Member States with a derogation’ was written into the TEU from the outset. Following the rejection of the Treaty of Maastricht by Danish voters in a referendum in June 1992, further compromises were struck between EU leaders on a number of opt-outs and derogations for Denmark, which cleared the way for a second referendum in Denmark and the eventual entry into force of the TEU on 1 November 1993. Thus, gradually, a ‘multi-speed’ Europe – Europe *à la carte* according to some – was born in which differentiated rights and obligations applied to different groups of Member States. The inclusion of general provisions on ‘closer cooperation’ – later renamed ‘enhanced cooperation’ – into the Treaties was only a further step in this process.

The possibility of a certain number of Member States establishing ‘closer cooperation’ between them on matters covered by the Treaties, using the institutions and procedures of the EU and EC, was first introduced by the **Treaty of Amsterdam**, which entered into force on 1 May 1999. Those first-generation enhanced cooperation provisions were never actually used but, as the institutional debate on the consequences of enlargement continued, the IGC which adopted the Treaty of Nice in December 2000 decided to amend those provisions in order to make them less restrictive and difficult to use in the context of the forthcoming enlargement of the Union to 25 and then 27 Member States.

The **Treaty of Nice** facilitates recourse to enhanced cooperation. The veto right which individual Member States enjoyed over the establishment of enhanced cooperation has been abolished (except in the field of the Common Foreign and Security Policy (CFSP), but this is not relevant for the purposes of this study) and the minimum number of Member States required for starting the procedure has been changed to the fixed threshold of eight Member States. The general provisions applicable to enhanced cooperation are laid down in Title VII of the TEU. In addition to those general provisions, there are specific provisions with respect to how the enhanced cooperation procedure is to be triggered and how other Member States may later decide to participate in an enhanced cooperation they were initially not involved in. These provisions vary across the three pillars, but for our purposes only those of the Treaty establishing the European Community (TEC) are relevant and will be further considered here. From the outset, it should be pointed out that, although enhanced cooperation has become easier since the entry into force of the Treaty of Nice in 2003,

the amended provisions have, to date, never been applied either, so there is no relevant practice that can be taken into account to evaluate the feasibility of recourse to enhanced cooperation for ETR purposes.

Article 43 TEU sets out the fundamental principles underpinning enhanced cooperation. It must contribute to enhancing the process of integration within the Union and must not undermine the single market or the Union's economic and social cohesion; it must not create a barrier to or discrimination in trade between the Member States and nor distort competition between them. The minimum threshold for establishing enhanced cooperation is fixed at eight Member States, regardless of the total number of Member States. **Article 43a TEU** provides that enhanced cooperation may be undertaken only as a last resort, when it has been established within the Council that the objectives of such cooperation cannot be attained within a reasonable period by applying the relevant provisions of the Treaties. **Article 44 TEU** provides that acts adopted within the framework of enhanced cooperation shall be applied by the participating Member States only and that their implementation shall not be impeded by the other Member States, and also stipulates that such acts adopted shall not form part of the EU *acquis*. However, according to **Article 43b TEU**, enhanced cooperation shall remain open to all Member States when it is established and they may decide to join in at any time, provided they then comply with the decisions already taken within the framework of the enhanced cooperation they choose to participate in. The Commission and the Member States are to ensure that as many Member States as possible are encouraged to take part in every enhanced cooperation. Finally, under **Article 45 TEU**, the Council and the Commission shall ensure the consistency of activities undertaken within the framework of enhanced cooperation with the other policies and activities of the Union.

The general conditions laid down in the TEU apply to enhanced cooperation in the first pillar areas covered by the TEC, which include certain aspects of taxation and environmental policy. However, **Articles 11 and 11a TEC** lay down the procedures specific to this pillar for the establishment of and subsequent participation in enhanced cooperation.

Member States intending to establish enhanced cooperation within the framework of the EC Treaty shall address a request to the Commission, which *may* submit a proposal to the Council to that effect. In other words, the Commission retains its exclusive and discretionary right of initiative, which is the rule in all first pillar matters, and thus may refuse to submit a proposal even when requested to do so by interested Member States. Moreover, if the Commission decides to make a proposal, authorisation to proceed with enhanced cooperation shall still be granted by the Council, acting by a qualified majority after consulting the European Parliament. Any member of the Council may request that the matter be referred to the European Council. Following discussion at the highest political level, the matter is referred back to the Council of Ministers, which may then act by the majority provided for in the Treaties. Though the veto right initially granted to the Member States by the Treaty of Amsterdam no longer exists, Member States which oppose the enhanced cooperation still have the power to delay it through a referral to the European Council.

An overview of the Treaties articles setting the rules and procedure of enhanced cooperation is provided in the table below.

Table 4 Summary table – provisions for enhanced cooperation in the Treaties

	Article	Subject	Implications for ETR
EC Treaty (TEC)	<u>11</u>	Procedure for establishing enhanced cooperation	Important, since procedural requirements must be observed for any measure in the form of enhanced cooperation, whatever its purpose
	<u>11A</u>	Subsequent participation of a Member State	Limited, since the participating Member States would have no interest at all in preventing another Member State from joining them later
Treaty on European Union (TEU)	<u>27A</u> to <u>27E</u>	Enhanced cooperation in the area of the Common Foreign and Security Policy (CFSP)	None
	<u>40</u>	Enhanced cooperation in the area of Justice and Home Affairs (JHA)	None
	<u>40A</u>	Procedure for establishing enhanced cooperation (JHA)	None
	<u>40B</u>	Subsequent participation of a Member State (JHA)	None
	<u>43</u>	General principles of enhanced cooperation	Important, since all these general principles apply to any measure in the form of enhanced cooperation, whatever its purpose (for discussion of individual principles see section 5.2) Relevant because this principle could be invoked by the Commission to refuse to make a formal proposal for ETR under the enhanced cooperation procedure, or by non-participating Member States within the Council to veto a decision to authorise recourse to the ETR procedure
	<u>43A</u>	Principle of last resort	Limited, for the same reasons as stated above under Article 11A TEC
	<u>43B</u>	Principle of openness	Important, for the same reasons as stated above under Article 11 TEC
	<u>44</u>	Decision-making under enhanced cooperation	None, since ETR measures by definition are to be fully implemented by the Member States and would require no resources for implementation by EU institutions
	<u>44A</u>	Cost of enhanced cooperation	Relevant, for the same reasons as stated above under Article 43A TEU
	<u>45</u>	Consistency with EU policies	

Source: Source: First 3 columns from European Commission general information website, 4th column added by authors

5.2 The possibility of having recourse to the enhanced cooperation for the purpose of environmental tax reform

Article 43 TEU lists an impressive number of substantive conditions which must be fulfilled by any proposed enhanced cooperation undertaken within the institutional and legal framework of the EU. Some of those conditions are not relevant to the matter of ETR. Others are relevant, but would not seem to raise any particular problems. For example, it would be easy to demonstrate, as appears from the above analysis of relevant Treaty provisions, policy documents and institutional practice, that enhanced cooperation on ETR **would further the objectives of both the EU and EC, serve their interests and reinforce their process of integration**, as required by Article 43(a). Such cooperation would clearly **respect the Treaties and the single institutional framework of the EU** (Article 43 (b)), **remain within the limits of the powers of the Community and not concern any areas of exclusive Community competence** (Article 43 (d)). Since there is hardly any relevant *acquis communautaire* it would not be difficult for such cooperation **to respect it**, as Article 43(c) requires. We will also assume, for the purpose of this analysis, that the **minimum threshold of eight Member States** needed to launch an enhanced cooperation can be reached, and that the **cooperation would be open to all the Member States**, in accordance with Article 43B TEU.

The remaining substantive conditions require more elaborate consideration. They are those set out in subparagraphs (e), (f) and (h) of Article 43 TEU. According to those provisions, it must also be established that the proposed enhanced cooperation on ETR **will ‘not undermine the internal market as defined in Article 14(2) [TEC] or the economic and social cohesion established in accordance with Title XVII [TEC]’, will ‘not constitute a barrier to or discrimination in trade between the Member States [nor] distort competition between them’ and will ‘respect the competences, rights and obligations’ of non-participating Member States.**

As regards the latter condition, it is to be noted that this was amended by the Treaty of Nice, since the corresponding provision introduced into the TEU by the Treaty of Amsterdam referred to ‘the competences, rights, obligations *and interests*’ of non-participating Member States.⁵¹ The Nice amendment had the effect of relaxing the conditions for resorting to enhanced cooperation, since it would easily have been possible for a Member State that opposed such cooperation, and had no intention to participate in it, to attempt to block it by claiming that it would violate its ‘interests’, whose definition, ultimately, always rests with the State concerned. Under the current wording, a non-participating Member State would have to demonstrate actual interference with its legally protected competences, rights or obligations under the Treaties, rather than merely assert a conflicting interest. Since other subparagraphs of Article 43 already refer, in different terms, to the participating Member States’ duty, in pursuing enhanced cooperation, to respect the Treaties generally (Article 43(b)) or specific provisions of the EC Treaty (Article 43(e)), it is doubtful whether Article 43(h) still entails any substantive obligation different from or additional to those resulting from the other subparagraphs. We will therefore refrain from further

⁵¹ TEU, as amended by the Treaty of Amsterdam, art. K.15(1)(f) (emphasis added).

discussing this particular condition and focus instead on the other two, which are potentially the most problematic for ETR. They concern the functioning of the internal market and the economic and social cohesion of the Union.

The internal market is defined in Article 14(2) TEC as *'an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of this Treaty.'* The key provisions concerning free movement are those laid down in Titles I and III of the TEC; the most relevant to ETR are those on the free movement of goods (Articles 23-31) and services (Articles 49-55), assuming that measures on the taxation of capital are not contemplated within the scope of ETR policies. While differences in taxation of goods and services between Member States have an impact on trade, this cannot automatically be viewed as *'undermining'* the internal market. To the extent that enhanced cooperation on ETR actually would reduce disparities between the fiscal policies of the participating Member States, it would be beneficial, rather than detrimental to the internal market. But this will not prevent vested interests from arguing the contrary.

As regards economic and social cohesion, this is a much vaguer notion that would be even more difficult to apply to the assessment of proposals for enhanced cooperation in the field of ETR. Article 158 TEC defines the objectives of cohesion policy in very general terms, referring to the *'overall harmonious development'* of the Community and, in particular, to the reduction of *'disparities between the levels of development of the various regions and the backwardness of the least favoured regions or islands, including rural areas.'* Under Article 159, Member States have an obligation to *'conduct their economic policies and (...) coordinate them in such a way as (...) to attain the objectives set out in Article 158.'* It can be argued that harmonisation of ETR policies through enhanced cooperation would be consistent with these objectives, all the more so since national tax policies in general and ETR policies in particular are, in principle, not aimed at specific regions within Member States. Only in very specific cases, where the impact of a particular ETR measure would disproportionately affect particular regions which are already economically disadvantaged for other reasons, and would effectively increase, rather than reduce disparities between the affected regions and other regions of the EU, could a case be made that this measure may negatively impact economic and social cohesion. It is a matter of proper design of ETR measures to avoid such impacts.

In addition to these substantive conditions, there are a number of procedural conditions that need to be fulfilled in order to have recourse to enhanced cooperation under the TEC. The most important conditions are (i) **authorisation by the Council** and (ii) **submission of a proposal for enhanced cooperation by the Commission**. According to Article 43A TEU, enhanced cooperation *'may be undertaken only as a last resort, when it has been established within the Council that the objectives of such cooperation cannot be attained within a reasonable period by applying the relevant provisions of the Treaties.'* Thus a formal Council conclusion to this effect is required before any further steps can be taken. The Member States who wish to initiate enhanced cooperation on ETR will need to ask the Council presidency to put this item on the agenda of the relevant Council formation (most likely ECOFIN) and to submit draft conclusions for approval. In parallel, the initiators also need to request the

Commission to submit a formal proposal for an act to be adopted under the enhanced cooperation procedure, which is a requirement that cannot be bypassed in any manner. This means that the Member States concerned will need to convince not only the full Council, but also the Commission that all the conditions for enhanced cooperation are fulfilled. Both the Council and the Commission have discretionary power in deciding on requests for enhanced cooperation. Such decisions would be intrinsically political in nature.

6 THE USE OF THE OPEN METHOD OF COORDINATION (OMC) TO SUPPORT A STEP CHANGE IN ETR

Open Method of Coordination (OMC) in a nutshell

The OMC was introduced by the European Council of Lisbon in 2000. It provides a framework for cooperation between the Member States to help drive their national policies towards certain common objectives. It takes place in areas which fall within the competence of the Member States (e.g. economic and social policy and fiscal measures). It usually focuses on: jointly identifying and defining objectives to be achieved (adopted by the Council); jointly establishing measuring instruments (statistics, indicators, guidelines); benchmarking, i.e. comparing national performance and exchanging best practices (monitored by the Commission).

Depending on the areas concerned, the OMC involves so-called ‘soft law’ measures, which involve a political commitment on the part of the Member States, but which never take the form of directives, regulations or decisions which would be legally binding. Under this intergovernmental method, participating countries are evaluated by one another (peer pressure), with the Commission’s role being limited to surveillance.

Examples: The use of OMC-like informal networks can be observed in ongoing processes such as the Sustainable Development Strategy, the European Climate Change Programme (ECCP), and sectoral networks, such as the Implementation and Enforcement of Environmental Law Network (IMPEL), the Common Implementation Strategy of the Water Framework Directive (CIS-WFD), and the Seville Process (implementing the Integrated Pollution Prevention and Control (IPPC) Directive). In addition, examples under development include Green Public Procurement and the EU strategy for an Integrated Maritime Policy.

6.1 Defining the Open Method of Coordination

The OMC as such is not mentioned in the Treaties. The 2000 Lisbon European Council coined the term ‘Open Method of Coordination’ and provided a definition (see Box below).

Box 8 2000 Lisbon European Council OMC definition

The OMC is a mean of ‘[...] spreading best practice and achieving greater convergence towards the main EU goals. This method, which is designed to help Member States to progressively develop their own policies, involves:

- fixing guidelines for the Union combined with specific timetables for achieving the goals which they set in the short, medium and long terms;
- establishing, where appropriate, quantitative and qualitative indicators and benchmarks against the best in the world and tailored to the needs of different Member States and sectors as a means of comparing best practice;
- translating these European guidelines into national and regional policies by setting

specific targets and adopting measures, taking into account national and regional differences;

- periodic monitoring, evaluation and peer review organised as mutual learning processes.

[...] A fully decentralised approach will be applied in line with the principle of subsidiarity in which the Union, the Member States, the regional and local levels, as well as the social partners and civil society, will be actively involved, using variable forms of partnership. A method of benchmarking best practices on managing change will be devised by the European Commission networking with different providers and users, namely the social partners, companies and NGOs [...].

At the very least, the **Lisbon Council's definition** provides a good first account of the OMC. According to it, the OMC aims to achieve '*greater convergence towards the main EU goals*'. The definition refers to various general mechanisms which are to be employed, namely:

- helping Member States to progressively develop their own policies
- mutual learning;
- comparing and spreading best practice;
- taking into account national, regional and sectoral differences;
- 'variable forms of partnership' between 'the Union, the Member States, the regional and local levels, as well as the social partners and civil society';
- the European Commission networking with different providers and users, namely the social partners, companies and NGOs.

The definition also lists a number of more specific instruments:

- fixing EU guidelines with short, medium and long-term timetables;
- translating EU guidelines into national and regional policies by setting specific targets and adopting measures;
- establishing quantitative and qualitative indicators and benchmarks;
- periodic monitoring, evaluation and peer review.

Two factors limit the utility of the 2000 Lisbon Council definition of the OMC. First, the definition exhibits a certain tension between the more general mechanisms listed above and the specific instruments. More specifically, it is not clear whether the definition prioritises functions, such as mutual learning and comparing and spreading of best practice, or whether the emphasis is on particular institutions and instruments, e.g. periodic monitoring and establishing indicators and benchmarks. This makes it difficult to establish whether a particular process conforms to the definition or not. For example, some processes may perform the functions without employing the instruments mentioned in the definition and (more likely) *vice versa*.

The second factor limiting the utility of the Lisbon Council's definition is the low degree of correspondence between the definition and the empirical reality of many existing OMCs. Of the two early 'prototype' OMCs which emerged several years before the Lisbon European Council, the European Employment Strategy (EES), which serves to coordinate Member States' employment policies at the EU level,

corresponds closely to the Lisbon Council's OMC definition. In contrast, the Broad Economic Policy Guidelines (BEPGs), designed to co-ordinate Member States' economic policies, differ significantly from this definition. Most importantly, this concerns functions: while the EES is designed as a bottom-up, inclusive learning process, the BEPG's main function is to ensure top-down surveillance of Member States. In institutional and instrumental terms this is reflected in the EES' mechanisms for broad participation and peer review on the one hand, and the closed, sanction-backed⁵² decision-making process of the BEPGs on the other hand.

The number of OMCs multiplied after the 2000 Lisbon European Council had introduced OMC as the institutional foundation of the Lisbon Strategy, which aimed at making 'the European Union (EU) the most competitive economy in the world and achieving full employment by 2010'. Unlike the BEPGs and the EES, these new OMCs have no robust basis in the Treaties. They address issues such as pension reform, health care, social exclusion, research policy, education and environmental technology. In terms of function, the new OMCs resemble the inclusive mutual learning approach exemplified by the EES much more than the top-down surveillance associated with the BEPGs. However, the degree of correspondence with the institutional and instrumental requirements of the Lisbon Council's OMC definition varies strongly, as different OMCs rely on different sets of relevant features. As former Belgian Minister for Social Affairs and Pensions, Frank Vandenbroucke, put it: The '*open coordination is a kind of a cookbook that contains various recipes, lighter and heavier ones*' (Vandenbroucke 2001, p. 4 and 2002, p. xxi). While it is possible to argue that some of these differences may be temporary and are likely to disappear once the respective OMCs will have developed more fully, other differences presumably reflect more profound variations among different issue areas and will therefore persist.

Against the background of these shortcomings of the Lisbon European Council's definition of the OMC, alternative definitions covering similar types of processes have been proposed. According to Sabel and Zeitlin (2008) EU governance is increasingly characterised by an 'experimentalist governance architecture', which is characterised by the following set of procedures:

- Establishment of framework goals and metrics;
- Elaboration of plans by 'lower-level' units for achieving them;
- Reporting, monitoring, and peer review of results;
- Recursive revision of goals, metrics, and procedures in light of implementation experience.

This definition can be interpreted as a clearer and condensed version of the Lisbon Council's definition of the OMC, containing the most essential OMC functions and institutional features. More specifically, the definition addresses the first problem with the Lisbon Council's definition - the lack of clarity pertaining to the relation between the functions of the OMC and its institutional and instrumental features. Sabel and

⁵² Through public 'naming-and-shaming' of Member States and – indirectly - through the link to monetary policy's various sanctioning options, including high fines for excessive budget deficits

Zeitlin's definition clearly frames the institutional features and instruments in terms of a bottom-up learning process.

However, the Sabel/Zeitlin definition still leaves the second shortcoming of the Lisbon Council's definition to be addressed: the low degree of correspondence between the institutional and instrumental OMC features required by the Lisbon Council's definition and the empirical reality of the OMC. This problem could be addressed by a further narrowing of the definition to the core characteristics of the OMC. According to this approach, the OMC is characterised by two core features:

- OMC function: bottom-up learning;
- Institutional features: recursive procedures of peer review at EU-level.

The value of this 'stripped-down' definition becomes particularly apparent if one takes into account that OMC research has identified numerous 'quasi' OMCs. These are not officially labelled as OMCs, but their functional and institutional characteristics sometimes correspond more closely to OMC definitions - including the Lisbon Council's definition - than the characteristics of some of the explicitly labelled OMCs. Examples of such quasi OMCs related to EU environmental policy include the EU Sustainable Development Strategy (EU-SDS), the Common Implementation Strategy of the Water Framework Directive (WFD-CIS), the European Climate Change Programme (ECCP) and measures to promote green public procurement (GPP) (Homeyer 2010; Homeyer 2007; ten Brink et al 2005).⁵³

While the definition of the OMC in terms of the core features of bottom-up learning and recursive procedures of peer review at EU-level may be more accurate than the Lisbon Council's definition, the latter remains an important point of reference. In addition to its political significance, the Lisbon Council's definition also has an important heuristic value and may serve as a more suitable first approach to identifying existing OMCs than the more abstract definition in terms of the two OMC core features.

6.2 How effective is the Open Method of Coordination?

First, a warning: there is sometimes a tendency to compare the effectiveness of the OMC with the 'ideal' effectiveness of EU legislation. However, any comparison between the two must take the limitations of both approaches into account. Thus the effectiveness of EU legislation is not only undermined by a generally quite significant implementation deficit, but also by the shortcomings of the legislative process. Relevant aspects include: the strong dominance of bargaining and negotiation modes of interaction (as opposed to deliberation) both within and among EU legislative institutions, strong influence of strategic behaviour and opportunism/power positions, failed legislative initiatives, limited adaptability of legislative measures over time and to local circumstances.

Assessing the effectiveness of the OMC is difficult. Many OMCs are quite recent, but are designed as long-term measures with a timeframe of 10, 20 or more years, so often

⁵³ For many potential examples from other policy areas, see Sabel/Zeitlin 2010.

only very preliminary assessments are possible. Furthermore, as the OMC is based on learning mechanisms, it is often not easy to distinguish the impact of the OMC from other impacts. Nonetheless, it is possible to arrive at some first conclusions. Important factors on which the effectiveness of the OMC depends include the following:

- There must be sufficient agreement on framework goals;
- Capacities in terms of personnel and data must be sufficient;
- Data must be reliable and comparable;
- The OMC must be sufficiently institutionalised – a committee of high level national and EU officials with sufficient expertise and capable of providing leadership is important. This should be supported by a secretariat and working groups; a link to a legal framework may be helpful with respect to institutionalisation;
- Access to knowledge and implementation experience is critical and must be expanded in the run of the OMC (or can even be newly created in the framework of the OMC).

6.3 The possibility of having recourse to the Open Method of Coordination for the purpose of environmental tax reform

Using the OMC to support ETR can have several **advantages**. OMCs have time horizons of several decades, which are suitable to the time horizon for radical ETR. Furthermore, the OMC can raise awareness for what the leading Member States are doing in terms of ETR – a point that was also raised in the interviews and questionnaire responses. The OMC can also enable mutual learning and exchange of best practice. The OMC is highly flexible, which enables it to take into account different situations in the Member States (for example with respect to aging and the size of the taxable population). In this regard, it should be noted that, over time, the OMC may allow for the emergence of different groups of Member States which share certain basic characteristics. The Members of one group may together develop a common approach to ETR. In a second step, a common framework for the groups may be developed. Similar developments took place in the case of the liberalisation of the electricity market, which may be comparable in some respects to the radical ETR case.

The questionnaires and interviews confirmed once again that the political odds against a legislative approach at the EU level – be it the Community Method or enhanced cooperation – appear to be very high. This reflects sovereignty concerns (subsidiarity issues) and the fact that taxation systems are highly embedded/entrenched at national level. Due to its non-legislative character, the OMC is far less affected by these factors. In addition, while the OMC would involve all Member States, there are considerable political concerns that using instead enhanced cooperation would create a precedent and lead to a split of the Community – a point that was also repeatedly made in the interviews.

In general, the OMC is less vulnerable to the contingencies of the legislative process and to lobbying and politicisation, not least by populists and eurosceptics, on the

sensitive issue of taxes. In the longer run the OMC does not exclude legislation, but may actually pave the way to the adoption of legislation. While it may be too early for EU level legislative steps towards ETR, an OMC could prepare the ground so that EU level action can be taken if a ‘window of opportunity’ opens up.

Choosing the OMC to support ETR, however, can also have some **disadvantages**, which need to be taken into consideration. There are some risks that additional harmonisation through OMC may not be sufficient to address concerns over competitiveness in the internal market, as the common guidelines developed in the OMC framework may be too flexible and cannot be legally enforced. However, this would only be a disadvantage if compared to legal harmonisation, as OMC is still considered a step forward compared to the status quo. In addition, as a result of the strong reliance of the OMC on reporting and monitoring and because of the recursiveness of the OMC, there is at least a theoretical possibility that effective (rather than legal) harmonisation may actually be higher under an OMC than under standard legal harmonisation, which may be undermined by loopholes, implementation deficits and insufficient monitoring.

As mentioned in the interviews, however, ensuring sufficient commitment by all actors may be difficult in the absence of a legislative framework. Member States may deviate from ETR guidelines and commitments developed in the framework of an OMC in reaction to domestic political pressure, a change of government etc. Nevertheless, this may be counteracted to some extent by keeping the option of an enhanced cooperation open - if only as a scenario to put pressure on OMC actors (‘shadow of hierarchy’).

7 PATHWAYS FOR INCREASED HARMONISATION: COMPARING OMC AND ENHANCED COOPERATION

According to Table 2 above, the two closest alternatives to an inclusive EU legislative approach to ETR are a non-inclusive EU legislative approach – essentially enhanced cooperation – or a flexible EU-level approach. The table associates the last option with various forms of the Open Method of Coordination (OMC).

If compared to enhanced cooperation, the OMC has the obvious advantage of being inclusive with regard to participation by all Member States – although, at least in theory, a non-inclusive OMC seems possible. On the negative side, the OMC is a ‘voluntary’ approach in the sense that, in contrast to enhanced cooperation, it does not directly result in the adoption of legally binding rules.

While differences between enhanced cooperation and the OMC with respect to the production of legally binding rules are important, one should be careful not to overstate these differences, and it should be noted that in some cases the OMC and enhanced cooperation may even coincide, or be seen as consecutive steps of a same gradual approach to achieve further harmonisation.

7.1 The potential for OMC and enhanced cooperation to drive further harmonisation in the context of ETR and environmental taxes

The OMC and enhanced cooperation can both be seen as ‘second-best’ choices. They are typically considered when taking recourse to the Community Method, which relies on the standard EU legislative procedures (usually the Co-decision Procedure), appears unrealistic and/or not desirable. However, which of the two alternatives to the Community Method is most suitable in a given case depends on the particular circumstances of that case. One could argue that if, as is the case with taxation, the Treaty provisions require unanimous decision-making in the Council for a certain policy area, and if some Member States consistently oppose the adoption of EU measures in that area, then enhanced cooperation may be the best ‘second-best’ choice, because it would allow for the adoption of legally binding rules at least in those Member States which are more keen to advance on a given policy area. However, if that would mean that only a small number of Member States, which have relatively a weak impact on the EU as a whole, would participate in an enhanced cooperation, then an inclusive although voluntary approach based on the OMC may be preferable.

However, as illustrated in the previous chapter, the legal constraints associated with enhanced cooperation are high. In addition, there are considerable political constraints – not least a significant unwillingness among Member States to agree on an enhanced cooperation for fear that this would set a precedent for using the instrument more widely. As these factors have so far prevented Member States from taking recourse to enhanced cooperation, the OMC remains an interesting option even when enhanced cooperation would, in theory, be preferable.

Nevertheless, using the OMC or enhanced cooperation are not necessarily two mutually exclusive alternatives – a point which was also made in the interviews. In fact, seeing the OMC as an alternative to enhanced co-operation is just one of at least three ways in which the two can be related to each other:

- Embedding OMC: enhanced cooperation is embedded in an OMC
- Enhanced Cooperation as OMC: enhanced cooperation takes the form of an OMC
- OMC as alternative to enhanced cooperation

Embedding OMC: As mentioned above, while the OMC does not directly result in the adoption of legislation, the respective contrast with the Community Method and enhanced cooperation should not be overstated. In fact, the OMC may often support the adoption of legislation. This would also be the rationale behind embedding an enhanced cooperation within a broader OMC, thereby combining the respective advantages of the two approaches. Under such an arrangement all Member States would participate in the OMC while, at least initially, only some would join the enhanced cooperation.

In this scenario, the OMC could be expected to support the adoption of legislation in two ways: first, by reducing political resistance to establishing enhanced cooperation in the first place and, second, by subsequently encouraging countries which do not participate in an enhanced cooperation to join the latter or, at least, adopt some of the measures which were agreed in its framework. The first effect would result from a reduction of the degree of exclusiveness of the enhanced cooperation: if the latter is embedded in an inclusive OMC, then those Member States which do not participate in the OMC will be able to better monitor, discuss and even influence the measures adopted in the framework of the enhanced cooperation. Consequently, the divide between the members and the non-members of an enhanced cooperation would be less severe and the loss of control of the latter over EU agenda-setting would be reduced.

The second effect would result from the mutual learning mechanisms which are at the core of the OMC. These would enable non-members of an enhanced cooperation to learn from the experience of the members and, conversely, the members would be able to learn about relevant issues in the countries which do not participate. With a view to extending the membership of the enhanced co-operation and/or the reach of its measures, some of these issues may then also be considered within the enhanced cooperation.

Whether or not it will be politically possible and desirable to embed an enhanced cooperation in an OMC is likely to depend to a large extent on the degree of support among a significant majority of Member States for the framework goal of the OMC. For the case of ETR this would mean that Member States would have to agree on the desirability of implementing the principles of ETR at least in the long term.

Enhanced cooperation as OMC: The degree to which the OMC is based on legally binding rules differs strongly among the various cases. While the BEPGs and the EES have a significant base in the Treaties, a comparable Treaty base is lacking for the ‘new’ OMCs adopted after the year 2000. Similarly, many new OMCs are not, or are only very weakly, anchored in EU secondary legislation. However, some new OMCs

have very close links to EU secondary legislation. This applies in particular to some of the quasi OMCs which have strong OMC features, but are not officially labelled as OMCs.

EU framework directives, which are largely procedural, may incorporate a quasi-OMC. As illustrated in the Box below, the Water Framework Directive (WFD) and its Common Implementation Strategy (CIS) exemplify the way in which a quasi-OMC – the Common Implementation Strategy, which is not mentioned in the Directive to which it refers – enables the implementation of an EU Directive, including the provision of critical support for the adoption of implementing secondary legislation (daughter directives) and comitology decisions (for details, see Homeyer 2010).

Box 9 The WFD-CIS as a quasi OMC

Institutional OMC characteristics

- WFD framework goal: good water status in 2015
- Regular reporting and peer review: WFD requires regular reporting and review of key aspects of implementation such as submitting updates of the environmental and economic analysis of river basin districts (Article 5), programmes of measures (Article 11), and river basin management plans (Article 13). The Commission is obliged to report on implementation of the WFD every six years (Article 18). The reporting and review is largely implemented through the structures of the CIS. The CIS equips the WFD with what comes close to a system of multi-level peer review. Essentially, the CIS has established a nested hierarchy of expert fora, ranging from the more political to the more technical. The water experts draft, review, and adopt guidance documents and other CIS output drawing on their technical and scientific expertise as well as country specific knowledge and experience. At the top of the CIS hierarchy is the meeting of the Member States' Water Directors.

Functional OMC characteristics

- Learning within the CIS evolved from a diffusion approach strongly dominated by a small group of Member States to experimental learning in the pilot river basins, to more inclusive mutual learning and peer review. This evolution can itself be seen as a learning process. The frequent revisions of the CIS work programme, which allowed for periodical reflexive analysis of the effectiveness and efficiency of its working methods, contributed to this learning process

An enhanced cooperation which pursues a relatively general framework goal, such as the implementation of more or less radical ETR within a timeframe spanning two or more decades, could similarly provide a legal framework for a quasi-OMC. While such an approach would, if anything, only slightly reduce principled resistance by some Member States against using enhanced cooperation and EU harmonisation of taxes, it would probably have a significant positive effect on the willingness of other Member States, with a stronger focus on substantive issues rather than principles, to join the enhanced cooperation. This is because such an arrangement would leave the development of substantive ETR measures to the implementation stage of the ETR. In addition to lowering the entrance barrier for non-members, an enhanced cooperation

designed as an OMC would also be significantly easier to adopt because decisions on substantive issues would not be necessary at the stage of initial adoption.

In contrast to an enhanced cooperation which is embedded in an OMC, enhanced cooperation as OMC does not require agreement among all Member States on a common framework goal. Only the members of the enhanced cooperation/OMC would have to agree to such a goal. In this respect, an enhanced cooperation as OMC would therefore be likely to face less political resistance than an embedded enhanced cooperation.

However, the opposite is likely to apply with respect to political resistance to using the instrument of enhanced cooperation as such. Of course, such resistance could probably be reduced if an enhanced cooperation as OMC would be embedded in a broader OMC – a construction that might in some respects resemble the structure of the Economic and Financial Affairs Council in which the Eurogroup is embedded.

OMC as alternative to Enhanced Cooperation: Although, as illustrated above, the OMC may complement or even coincide with enhanced cooperation, it can also serve as an alternative tool. Two basic scenarios are relevant in this respect. First, political resistance to enhanced cooperation may be too strong. Issues of sovereignty and overarching concerns related to the division of competences between the EU and Member States are frequently at the core of this type of political resistance.

Another important aspect are possible concerns related to the so-called ‘multi-speed Europe’. In this case pragmatic reasoning may lead to a preference for OMC over enhanced cooperation, especially if unanimous Council decision-making applies.

However, Member States may also prefer OMC for substantive reasons. They may feel that legislation is not sufficiently flexible to account for legitimate national differences and contingencies, or to allow for long-term contingencies. There could also be insufficient knowledge and experience for a legislative approach which could be gathered and tested during a first OMC phase.

7.2 Conclusions on harmonisation

It appears that enhanced cooperation on ETR is feasible under the Treaties from a legal viewpoint. Given the slow progress of ETR at EU level under the normal decision-making rules which require unanimity, a strong case could be made for recourse to the OMC or enhance cooperation in this field.

Radical ETR is a long-term project. It is impossible at the present time to predict which instruments will or could realistically be used to implement radical ETR in ten, twenty or even more years.

A legislative approach to ETR appears to be unrealistic at present. There continues to be considerable political resistance from Member State governments against political moves which could be interpreted as a formal transfer of competences in tax matters

from the national to the EU level. A legislative approach would necessarily entail such a transfer.

There is also a significant danger that efforts to adopt EU legislation would play into the hands of eurosceptics. Despite the significant rise of euroscepticism in the 1990s and beyond, most EU citizens welcome a strong role of the EU in environmental policy. However, taxation is a politically much more sensitive issue. Efforts to adopt EU legislation on ETR could therefore lead to a politicisation of the issue in many Member States. This politicisation might easily be as much about the issue of ETR itself as about EU competences.

There is nothing in the Treaty provisions on **enhanced cooperation** that would prevent its application to ETR. However, the discretionary power that the Council and Commission must exercise in order to trigger an enhanced cooperation procedure is substantial, and so it appears that the obstacles to be overcome will be largely political, rather than legal in nature.

From a political perspective, enhanced cooperation may face significant opposition. While it might well be possible that eight or more Member States would be willing to pursue ETR on the basis of enhanced cooperation, it is possible that the remaining Member State may not accept such a move for fear that it might lead to a ‘creeping’ erosion of their tax competences and might set a precedent that would pre-determine any future substantive EU policies in this area. Insights from the questionnaire responses revealed that some consider that enhanced co-operation cannot improve existing tax harmonisation, as community legislation can only be improved by means of a new Community act. Although Member States are free to co-operate, in area where harmonised legislation exists their activities should not clash with the harmonised rules. Perhaps most importantly, many Member States appear to be unwilling to take recourse to enhanced cooperation because of the potential implications for the unity of the EU. Also, in the context of the current global consultations on climate change, it was feared that forms of closed cooperation among a small group of European countries could potentially affect the overall EU negotiating position.

The political circumstances surrounding ETR at EU level seem to speak more in favour of an **OMC** approach, at least in the short term. Pursuing ETR through an OMC would encounter much less political resistance than legislation because it would leave formal competences for tax matters firmly at the national level. In addition, the OMC lends itself much less to politicisation than the legislative process, which is more prone to the pursuit of national interests in the Council and party politics in the European Parliament.

In addition to these pragmatic arguments, the OMC has several advantages. In particular, the OMC seems to fit the long time horizon of radical ETR and the fact that national tax systems and situations with regard to, for example, the future development of the taxable population, differ strongly from one another while, at the same time, tax systems are deeply entrenched in broader national economic and social policies. The importance of this deep-seated national diversity was also raised in the interviews and questionnaire responses.

The basic mechanism on which the OMC relies - mutual learning from experience – seems to fit this context of deeply entrenched, highly variable and politically highly sensitive national contexts and situations. Finding political compromises through legislative bargaining and compromise is extremely difficult in these circumstances due to high information requirements and political sensitivity. Learning-based mechanisms serve to provide information and may lead to better mutual/multi-lateral understanding and, in a second step, adjustment.

Another advantage of the OMC is that it can bring together a broad spectrum of actors in a relatively informal and depoliticised context. This is an advantage not only with respect to the questions of subsidiarity, but also with respect to balanced involvement of officials from different departments – in particular finance and environment – and civil society and stakeholders.

Finally, the OMC, enhanced coordination and future legislation are not mutually exclusive. In fact, by improving the information base and creating relevant contacts among officials from different departments and levels of governance as well as with civil society and stakeholders, the OMC is likely to support a legislative approach in the medium to long term. In order to further reduce political resistance to pursuing radical ETR at the EU level and to stabilise the OMC itself, it could then be combined with legislation in several ways. In particular, the OMC could reduce political resistance to enhanced cooperation, if the latter was embedded in an OMC, and the OMC itself could be institutionalised more strongly if it was itself based on procedural EU legislation conforming to the OMC requirements. This could happen both in the framework of enhanced cooperation or more broadly using the Community Method.

While political resistance to the OMC can be expected to be much lower than resistance to a legislative approach, the OMC is unlikely to succeed if it is not backed by a sufficiently broad consensus on the necessity of the framework goal of medium- to long-term radical ETR and sufficient institutional capacity and stability. The success of the OMC depends on whether or not EU institutions and, in particular, Member States are willing and capable of providing for these conditions. For OMC to make a significant difference, and have any hope of achieving the step change to a 15 per cent of tax revenue ‘target’ as identified by many of the experts, there will need to be a step change in the OMC application itself – i.e. to become a strong tool that meets its potential. This will require a level of commitment beyond that applied in many existing OMCs.

In the medium to long term it may also be conceivable to change the requirements for enhanced cooperation under a future treaty change, in the course of future EU enlargements (e.g. wider Balkans), to make it easier to implement. Encouraging strengthened OMC can be a useful bridge/foundation for this. A type of ‘enhanced coordination’ could also be an option where a small group of Member States cooperate under own coordination (rather than under Commission coordination) to move one step and avoid competitiveness impacts. This would be a type of hybrid between OMC and enhanced cooperation.

8 CONCLUSIONS AND RECOMMENDATIONS

ETR can be an important tool to help facing today's and tomorrow's environmental challenges related to climate change, water scarcity, energy security and general resource limits (i.e. living within one planet's resources). Even a modest tax shift can be helpful to provide positive signs to the economy in terms of putting the right price on resources, making polluters pay and alleviating pressure on more 'benign' goods like labour. Also, arguably, revenues raised through green taxes can help make up losses in revenue that are expected to come from labour taxes given demographic changes in the long term and, in the short term, for increasing national debts caused by the recent economic and financial crisis.

The ideal share of environmental taxes over total fiscal revenue is difficult to assess, but many experts believe that **a doubling of environmental taxes - from 7 to 15 per cent** - can be feasible in the medium-long run (2020 to 2050).

Many experts see a doubling of environmental taxes' contributions to tax revenues (currently averaged at around 7% of revenues for the EU) over the period to 2050 (to around 15%) as needed, appropriate and feasible.

- a. This is needed to address environmental challenges of climate change, water scarcity, energy security and general resource limits ('One planet economy'). Environmental instruments that can contribute include: vehicle taxes, fuel taxes, resource charges, auction revenues
- b. This is needed to make up losses in revenue from labour taxes expected to come due to demographic changes.
- c. Get the signals right in the economy as currently market mechanisms, prices/costs do not lead to the optimal use of resources or 'optimal pollution levels' (e.g. where pollution damage 'acceptable' given trade-off with other benefits (e.g. greater economic benefit), taking into account substitutability issues)

Green taxes, however, are not a panacea for all environmental problems, and should **work in parallel with other market and non-market instruments, including regulation, ETS and the removal of harmful subsidies.**

To move towards doubling of environmental tax contributions – requires a fairly radical change

- a. Systematic application of taxes that work – building from existing good practices. Scope for road pricing/congestion charging, waste taxes, air pollution taxes, resource charges, effluent taxes.
- b. Taxes/charges need to be increased where they exist – e.g. excise tax (possibly indexed to the consumer price index, as in the Netherlands and Sweden).
- c. New taxes are needed – aviation taxes.
- d. Auctioning needs to become the norm.
- e. Subsidies will need to be reformed

Not all policy areas/sector are likely amenable to environmental taxes. In general, there is scope for ETR to help tackle climate change, especially the mitigation aspect – where taxes on energy/emissions should be seen as a complement to ETS by addressing the non-ETS sectors and other emissions. Taxes can also be useful to stimulate resource efficiency, by placing the right price signal on scarce resources such as water, minerals and gravel - as shown in the PetrE project where a tax on material inputs is simulated, generating revenues almost in the same range as the pricing of carbon. Water pricing, for instance, can help tackle water scarcity, which is an increasingly serious issue in Europe. Waste taxes – e.g. landfill taxes and charges – can also help curb the production of waste and stimulate re-use and recycle. For other sectors – such as biodiversity, chemicals and renewable resources – fiscal instruments can be less effective, and other instruments should be taken into account. In general, the introduction of environmental taxes should be made on a case-by-case basis, carefully evaluating the most effective tool for each specific environmental area and objective.

There are a number of existing areas that can contribute to the ETR, and a number of new areas. These include

- a. There is major scope for the example set by leading countries – e.g. on carbon taxes, landfill taxes, pollution taxes, circulation charges, product taxes, natural resource charges – to be applied by administrations in other countries. There is significant scope for early and late followers and even laggards to adopt useful tools that have proven effective in other countries.
- b. There remains scope for revising and extending existing instrument – e.g. level of excise tax, level of auctioning, landfill tax rates. This is not a ‘new instrument’, but adjusting the rates, which offer requires a different policy route (e.g. not requiring primary legislation in some cases).
- c. There is also scope for new instruments – such as land use taxes/charges (e.g. for conversion of land) and maritime fuel taxes (the latter could potentially raise significant revenues).
- d. There is scope for leverage – e.g. link structural fund allocation to existence of green taxes.
- e. Fiscal reform, also includes subsidy reform – and while not specific focus of this study, it is clearly an invaluable part of the package - also for public acceptability in cases where monies are clearly spent ineffectively and going to the ‘wrong’ people.

The political climate over the past 10 years appears to be less inclined towards a more substantial tax shift from labour to environment. However, **long-term environmental objectives agreed at national and EU level makes imperative to use the measures available, including environmental taxation**, to achieve the target set. If in the short run it is difficult to expect immediate significant and widespread changes in the tax composition, it is desirable that in the medium-long term the relative share of environmental taxes will increase in order to provide the right signal to the economy. There is a need for a paradigm shift in willingness for politicians to support ETR. There is an opportunity now with the current economic crisis, though the risk is that politicians focus on new subsidies, rather than on reforming subsidies and reforming the wider tax system.

The ETR shift is not expected to start in earnest in the short term, with some select exceptions, given lack of political courage.

- a. Political courage is not expected to be sufficient for new taxes, despite new rhetoric/political statements supporting ETR.
- b. Currently, the focus in the crisis is more on offering new subsidies rather than raising taxes. Even new subsidies do not make full use of environmental issues
- c. While generally the opportunity for ETR has been missed in the current crisis, there may, however, be an opportunity when budget it becomes imperative to balancing the budget.

If seen from the perspective of achieving given environmental objectives, green taxes can be seen either as a permanent or temporary tool. A typical criticism moved to green taxes for instance is that, by definition, if their objective is met (i.e. reducing pressures to the environment) their tax base is due to shrink over time. On one hand, however, green taxes can be seen as a way to promote increasingly ambitious targets, or to tackle changing environmental problems; once they are solved their aim is simply accomplished and it could be assumed that there is no more need for them. On the other hand, assuming that environmental policies and objectives are dynamic and change over time (as new problems may emerge, old targets are not met, etc.), taxes can be easily redirected to achieve new objectives. In this sense, they can be seen as a permanent tool. The tax basis, however, is likely to be fluctuating rather than stable, with environmental objectives gradually being achieved and new targets set. This reinforces the idea that the primary use of environmental taxes should be the environmental objective and, only as a second-order goal, revenue rising.

The traditional arguments to overcome barriers to the introduction of ETR remain valid and still convincing. Resistance to ETR does not seem to be attributable to a lack of solid arguments to back its usefulness. Rather, this seems to be due mainly to a general lack of political will to introduce ‘braver’ reform, especially due to the fear of upsetting strong economic lobbies. There is also a general resistance towards the concept of ‘taxes’. The expression ‘Environmental Tax Reform’ can be in some cases be difficult to market, as tax payers tend to associate it with increased fiscal pressure. Raising awareness of citizens and business also appears to be a crucial issue.

The sectors most affected by environmental taxes are especially the energy intensive industries and the biggest polluters, which are frequently large organisations with strong lobbying influence. The sectors which could benefit from a wider use of green taxes, such as the renewable energy sectors or other business relying on eco-innovation and technology, are instead often relatively small and less organised. They therefore tend to be less informed about policy proposals and also have a smaller role in influencing political decisions. This could partially explain why ‘losers’ have historically spoken louder than ‘winners’. **It will be appropriate to mobilise the ‘winners’ to fully appreciate the benefits of ETR.**

Despite some convincing arguments in favour of ETR have been developed, it appears that these have not been effectively communicated to the potential beneficiaries of

such a reform – i.e. those that could benefit from reduced labour taxes and also those economic sectors that could benefit from economic stimuli to green technologies, eco-innovations or energy and resource efficiency. Experience (e.g. from the UK) shows that **transparency in the way tax shifts are applied and appropriate communication of the benefits of ETR are of the essence** to minimise political and social opposition and increase acceptability.

Social acceptability is critical for political acceptability and commitment. Experience suggests that right communication and right design can help with social acceptability.

- a. Communicating the benefits has proven useful (e.g. in Germany)
- b. Linking tax/charge rises to use of the revenues (e.g. for environmental investments) has given clear understanding to the public that it is not about simply raising taxes.
- c. Linking tax rise with social security/employment taxes also helps – though sometimes the effects are small and hence there is some scepticism.
- d. Environmental taxes, launched as part of a package (e.g. with reform of some subsidies) can facilitate the appreciation of the benefits.

Political and public/social acceptability will be influenced by events and understanding of issues and policy makers should prepare for windows of opportunity.

- a. Water stress, climate change/energy security are issues that offer opportunities for instrument changes.
- b. Appreciation of the simple physical limits of natural non-renewable and renewable resources will increasingly take place as the limits become evident (resource prices picked up by market, resource losses visible – e.g. fish stock, land for landfills).
- c. There will most likely be a range of new events (drought, aquifer depletion, climate events, energy security issues) in the coming 10, 20, 40 years that policy makers should prepare to make use of to move taxes/fiscal systems to help offer needed signals to the market.

Historically, the use of ETR has been mainly promoted by northern European countries, such as Sweden, Denmark or the Netherlands, and other countries like Germany, the UK and France. Southern Europe has been less keen on environmental taxes, while the new Member States are only recently familiarising with the concept – although with some virtuous examples such as Estonia and Slovenia. It is currently expected that the inclination of these countries will likely remain the same in the short-medium term. However, arguably, **a stronger signal in favour of ETR from the EU institutions could help win over some resistance in less keen Member States** and contribute to raising awareness on the benefits of a tax shift at EU, national and regional level.

Increased harmonisation is often considered an essential element to encourage Member States to adopt more radical ETR as currently its use and the size of

environmental taxes are very uneven across Europe. A more harmonised approach could reduce the risk of distorting competition and would generate a common playing field in the EU. Fiscal matters, however, are subject to unanimity voting in the Council, and this historically has made the introduction of bolder tax reform a challenging issue given the difficulty to reach agreement. The need to find other forms of collaboration in the field of environmental taxation therefore is significant.

A more harmonised approach to ETR and green taxes can reduce the risk of distorting competition and generate a common playing field in the EU.

- a. ‘Copying others’ will offer some benefits, but not enough for a significant change in environmental tax contributions.
- b. This should offer progress in a range of areas (e.g. resource pricing) where there is scope for action given the internal market considerations (i.e. the Commission has a bone-fide role).
- c. In some areas there will be no mileage, given Member State sensitivities – e.g. vehicle taxes, which many countries see a ‘red line’ as regards European institution involvement.

Ideally, like-minded countries should agree on common goals and/or procedures in the field of ETR and implement reforms that, if successful, could convince other countries to join in. Such approach could be amenable to the **enhanced cooperation** procedure, where a group of countries (at minimum eight) agree on a common set of rules or goals to be implemented at national level. Enhanced cooperation, however, has never been tried before in any area of the EU acquis. The difficulty of this approach lies in the difficulty to ascertain, as required in the Treaty of Nice, that the matter cannot be solved ‘*within a reasonable period by applying the relevant provisions of the Treaties*’. This would in fact require a *de facto* admission of failure of the EU institutions to deal with some fiscal matters, which may encounter political resistance.

A less controversial approach will be the **Open Method of Coordination (OMC)**, which has already been applied in a range of policy areas. The OMC, however, is considered in some cases a rather weak approach, as no binding commitment is adopted by Member States.

A possible (radical) solution will be to **change the requirements for enhanced cooperation** under a future treaty change, in the course of future EU enlargements (e.g. wider Balkans). **Encouraging strengthened OMC can be a useful bridge/foundation for this.** A type of ‘enhanced coordination’ could also be an option where a small group of Member States cooperate under own coordination (rather than under Commission coordination) to move one step and avoid competitiveness impacts. This would be a type of **hybrid between OMC and enhanced cooperation.**

Enhanced cooperation, while in principle possible, currently looks impossible in practice; yet it will be required if environmental tax reform is to reach its potential; it may also be necessary in the context of an enlarged EU.

- a. The current requirement to show that existing initiatives (e.g. legislative proposals) can only fail before enhanced cooperation can take place is a major barrier.
- b. There is currently no appetite for reforming the rules.
- c. There may be a need and opportunity in the future – eg with treaty changes needed as EU enlargement continues. (e.g. could be a deal maker as regards Turkish inclusion in the EU?).
- d. A strong politically led commitment to ETR/EFR combined with strong commitment to OMC will be needed to make it the reform happen.
- e. Link with existing platforms and, in particular, with proposals to create an MBI Forum in the context of the MBI Green Paper can be a useful starting point and should be further explored

The joint challenges of climate change, resource constraints, needs for innovation, energy security, environmental impacts as well as an aging population may together create the conditions for a **new momentum for a radical approach on ETR**. Recent growing interest in new carbon taxes, carbon-based vehicle taxes, product taxes and a move to full cost recovery for water pricing, all indicate a growing political acceptance of a need to progress on ETR. EU enlargement with its associated increased difficulties in getting unanimity, however, will make an EU-wide legislative approach for ETR increasingly difficult. The tension between a more recognised need for ETR and growing difficulty of an EU-wide approach, together with the limits of ‘soft’ approaches such as OMC, may create the conditions for exploring ‘enhanced coordination’ and even open the door to changes in legal requirements to ease the use of formal enhanced cooperation.

For a radical ETR, there is a need for long-term vision, statement of political aspirations, a strategy, and a road map with objectives and targets for ETR.

- a. Commitment to having market signals contribute to the sustainable use of resources and products – ‘getting prices right’.
- b. Commitment to the polluter pays, full cost recovery and user pays principles
- c. Targets for full auctioning.
- d. A target of 1% per year environmental tax increase as a general rule.
- e. Commitment to at least an enhanced OMC on these matters across Europe and collaboration internationally.

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ANNEX I – THE QUESTIONNAIRE

This annex includes the questionnaire circulated to collect views on feasibility and acceptability of ETR. It has also been used as a basis for some selected interviews. This version of the questionnaire has been circulated to ETR experts and officers of EU/international institutions. Slight variations have been circulated to MS representatives and business associations.

A total of 20 replies have been received, and 11 interviews were undertaken. We are very grateful for the useful insights provided by the respondents – listed, among other contributors, in the acknowledgements section in page 2.

Collection of Views on the Feasibility of Implementing a Radical Environmental Tax Reform (ETR) and its Acceptance

Questionnaire in the context of the European Environment Agency (EEA) ‘Study on Tax Reform in Europe over the next decades: implication for the environment, for eco-innovation and for household distribution’

This questionnaire aims to gather useful insights and opinions regarding environmental tax reform (ETR), the acceptability of a radical introduction of environmental taxes and the way to achieve greater harmonisation across the EU in the field of ETR. We are adopting a long term approach in order to understand the real interest and potential for a significant tax shift to achieve ambitious environmental, natural resources and climate change objectives in a world of growing populations, increased competition for natural resources, and increased stress on ecosystems.

The information gathered through this questionnaire will feed in the EEA ‘Study on Tax Reform in Europe over the next decades: implication for the environment, for eco-innovation and for household distribution’ led by Kommunalkredit Public Consulting GmbH (KPC) in collaboration with the Institute for European Environmental Policy (IEEP), Gesellschaft für Wirtschaftliche Strukturforchung (GWS) Cambridge Econometrics, Ecologic, Policy Studies Institute (PSI) and King’s College London (KCL). The information gathered will specifically feed into the section ‘Feasibility implementing a radical ETR and its acceptance’, for which IEEP is responsible.

Some preliminary information regarding ETR is provided below. This aims to provide an overview of some key issues related to environmental taxes and the theories supporting them, as well as clarify some definitions and approaches referred to in the questionnaire. It will be helpful therefore if you read this introduction before answering the questionnaire.

We will very much appreciate if you could reply to the questions included at the end of this document or to a selection of them, according to your expertise and the areas in which you are keener to contribute.

Note that if you prefer we can proceed by phone interview rather than paper questionnaire.

Introduction: ETR in context

Environmental tax reform (ETR)⁵⁴ refers to ‘a gradual shift of the tax base away from taxing ‘good resources’ such as investment and labour, toward taxing ‘bad resources’ such as pollution and inefficient use of energy’ (EEA, 2005)⁵⁵.

Environmental taxes usually refer to taxes, charges and fees. In this questionnaire the expression ‘taxes’ is meant to cover all these tools. Nevertheless it is useful to keep in mind their specific definitions, where:

- A ‘tax’ is ‘any compulsory, unrequited payment to general government levied on tax-bases deemed to be of particular relevance. Taxes are unrequited in the sense that benefits provided by government to taxpayers are not normally in proportion to their payments’ (OECD 2001, p.15).
- ‘Charges and fees’ are compulsory and requited payments to general government or to bodies outside general government, such as environmental funds or a water management boards. Examples include waste water charges, abstraction charge and waste charges.

Some examples of common environmental taxes are provided in Box 1 below.

Box 1 Environmental taxes - examples⁵⁶

- D) Air/Energy: CO₂, SO₂, NO_x, fuels
- E) Transport: Car sales/registration taxes, annual car circulation tax
- F) Water: Water effluent charges, water pollution taxes, water abstraction charges
- G) Waste: Landfill tax, dangerous waste
- H) Noise: Aviation noise
- I) Natural resources: Gravel, Sand, Land use charges
- J) Products: Tyres, Beverage containers, Packaging, Plastic bags, Batteries, Light bulbs, Fertilisers, Pesticides, Solvents

ETR is usually associated to the idea of ‘double dividend’, i.e. the hypothesis that ETR can lead to improvements in both the environment (by properly pricing

⁵⁴ The term ‘Ecological Tax reform’ and ‘Green tax reform’ are also frequently used. ‘Environmental Fiscal reform (EFR)’ instead refers to a broader concept that includes reform of environmentally harmful subsidies.

⁵⁵ EEA. 2005. *The European environment – state and outlook 2005*. State of environment report no 1/2005

⁵⁶ Based on EEA. 2006. *Using the market for cost-effective environmental policy - Market-based instruments in Europe*. EEA Report No 1/2006

externalities) and to the economy as a whole, leading for example to more employment as labour becomes cheaper.

Many benefits have hence been attributed to ETR – not only from an environmental point of view (reduced pollution, reduced natural resource use) but also from a social perspective (health, equality, and employment) and economic perspective (resource efficiency and associated savings, increased innovation and new technologies and markets). Some also argue that environmental taxes have the advantage to be less distortionary than capital and labour taxes, i.e. they can reduce economic inefficiency and improve welfare. Also, ETR may have the potential to respond to the expected decline of European population (leading to a decrease in the labour tax base) by shifting part of the tax burden from the shrinking working population onto the expanding and long living population of lifetime consumers.

Nevertheless, it is clear that several barriers and criticism to ETR implementation still exist, such as the fear of an increase in the cost of production (despite cheaper labour cost), negative impacts on international competition, potential effects on inflation, perceived impacts to low income groups, or simply political caution near elections.

Several examples and good practices have proved how the perception of some of these obstacles is in some places wrong, or showed the way to overcome them. However, there is still a general lack of confidence in a possible future shift towards more radical ETR, and currently the uptake of environmental taxes has still been relatively small (less than 7% of total tax revenue in 2005 in the EU27)⁵⁷. There is also a general lack of vision as to what a more appropriate tax structure could be in the absence of political pressure and vested interests.

In light of the recent discussion on the ‘green new deal’ and the opportunities to link environmental measures to a recovery of the EU economic and fiscal system, a gradual introduction ETR could be seen as a move in the right direction, with some new environmental taxes introduced in the near future and a more radical shift from labour to environmental taxes in the long run.

By starting to consider what targets will need to be achieved and what tools should be used in the ideal future (e.g. 2050), one can work backwards to identify what measures will have to be implemented in the nearer future, i.e. what could be achieved in the medium period (e.g. in 2020) and what steps should be taken in the short run (e.g. in the next 5 years).

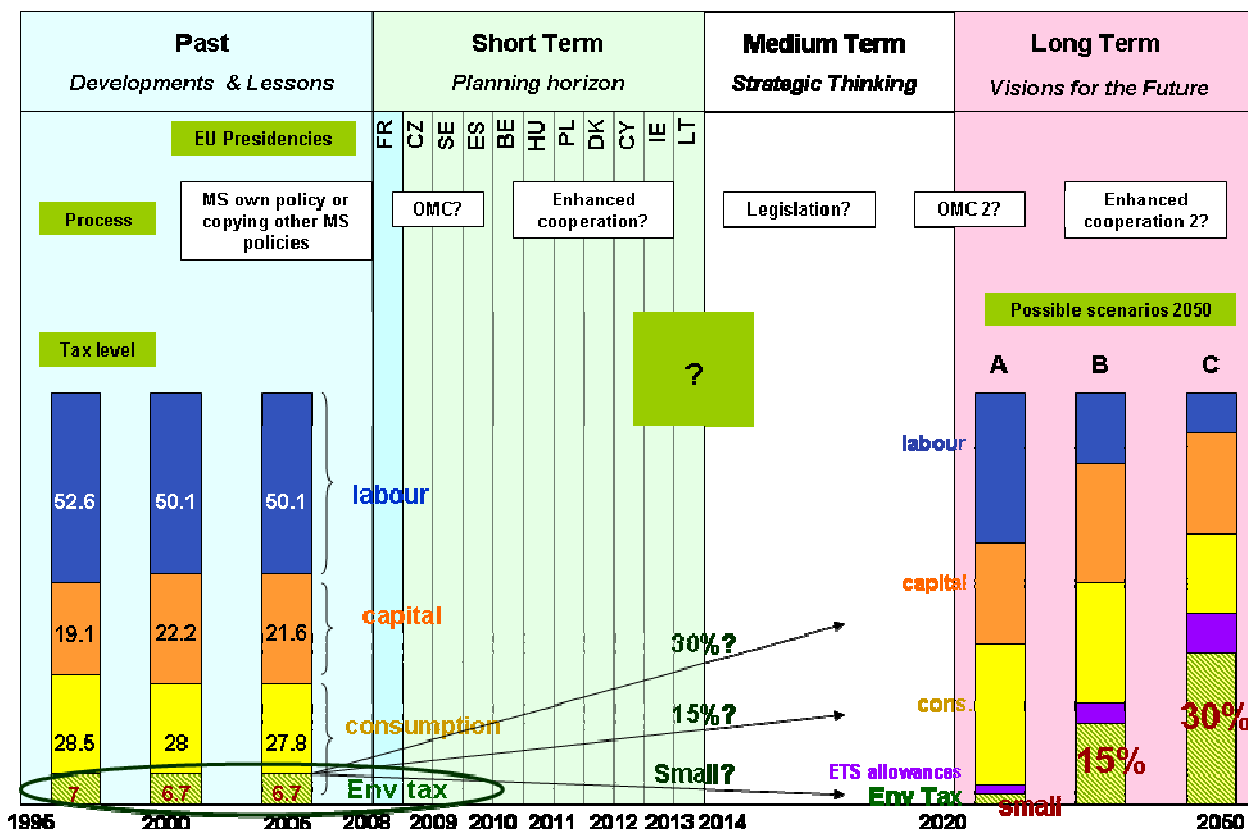
The figure below provides a schematic timeline for basic future scenarios for 2050 to help create a structure around which to talk/debate. Possible scenarios could be:

- K) A: minor changes – reduced income from labour, compensated by some additional capital and consumption taxes - slight increase of environmental taxes but not substantial

⁵⁷ European Commission. 2008. *Taxation trends in the European Union. Data for the EU Member States and Norway*. Eurostat Statistical Books

- L) B: significantly reduced income from labour, compensated by consumption taxes. Increase of environmental taxes up to 15% of total revenues – i.e. ~ doubling of current level
- M) C: (extreme case – for illustrative purpose) almost complete substitution of labour taxes with capital and consumption taxes. Environmental taxes provides for up to 30% of revenues or more

Figure 1 ETR dynamic in the short, medium and long term



The issue of harmonisation: Taxes are mainly set nationally or sub-nationally and the harmonisation of taxation rules at EU level is subject to the unanimity rule. As a consequence, few developments have been achieved at EU level. Undertaking a more radical ETR at national level can be hard in the context of competition within the internal market and globally. The way forward has to date been more of cautious⁵⁸ introduction of a new tax by one country, with other countries then ‘following the example’. There has been therefore a step-by-step progress, with some *de facto* harmonisation as followers adopted other member states’ approaches. Overall progress, however, has been relatively slow.

The questionnaire wishes to explore whether further harmonisation on ETR will be desirable and, if so, how this could be achieved. Different tools to increase ETR harmonisation across the EU are available, from formal legislation to different forms

⁵⁸ Note that even cautious introductions can be relative radical of course in light of political realities.

of collaboration between Member States. Some key approaches are summarised in the following table – see also definitions in the box below:

Table 1 Approaches to achieve ETR at EU level

Level of harmonisation	Approaches and examples for tax reform	
Tight harmonisation for a subset of EU Member States	Legal approaches and not all EU – special legal framework outside EU legal framework	Eg as early Schengen co-operation.
	Legal approaches and not all EU – within existing legal framework	Schengen process; EURO zone Enhanced cooperation – e.g. potentially for carbon tax?
Increased harmonisation across the EU ↑ Partial harmonisation across the EU ↑	Legal approaches implemented across all EU	Legislative specific <u>minimum requirement</u> : energy tax directive, VAT
		Legislative general requirement : 'principle of recovery of the costs of water services' under WFD ⁵⁹ for water pricing
		Legislative possibility : Eurovignette
	Political intention to promote fiscal reform: Flexible approach	Formal/structured Open Method of Coordination (OMC) e.g. Lisbon Strategy, Broad Economic Policy Guidelines (including vague ETR recommendations)
		More flexible/light OMC – e.g. <i>Green public procurement (GPP)</i>
		' Encouragement of voluntary policy coordination / towards OMC e.g. <i>Cars and CO2: encouraging national fiscal approaches; reform of environmental harmful subsidies</i>
No harmonisation	Subsidiarity / full own choice but 'learning from others'	Compare and respond to other Member States' initiatives – e.g. use of revenue neutrality
	Subsidiarity / full own choice	Own needs and own initiatives – e.g. UK Landfill tax with ETR approach

⁵⁹ Unanimity was not required for WFD because this was under Art 175(1)

Box 2 Harmonisation approaches - some useful definitions⁶⁰

Open method of coordination (OMC): The OMC was introduced by the European Council of Lisbon in March 2000⁶¹. It provides a framework for cooperation between the Member States (MS), to help drive their national policies towards certain common objectives. It takes place in areas which fall within the competence of the MS (e.g. economic and social policy and fiscal measures). It usually focuses on: jointly identifying and defining objectives to be achieved (adopted by the Council); jointly establishing measuring instruments (statistics, indicators, guidelines); benchmarking, i.e. comparison of MS' performance and exchange of best practices (monitored by the Commission).

Depending on the areas concerned, the OMC involves so-called 'soft law' measures which involve a political commitment on the part of the MS but which never take the form of directives, regulations or decisions which would be legally binding. Under this intergovernmental method, the MS are evaluated by one another (peer pressure), with the Commission's role being limited to surveillance.

Examples: The use of OMC-like informal networks can be observed in ongoing processes such as the Sustainable Development Strategy, the European Climate Change Programme (ECCP), and sectoral networks, such as the Implementation and Enforcement of Environmental Law Network (IMPEL), the Common Implementation Strategy of the Water Framework Directive (CIS-WFD), and the Seville Process (implementing the IPPC Directive). In addition, examples under development include Green Public Procurement and the EU strategy for an Integrated Maritime Policy.

Enhanced cooperation: Enhanced cooperation allows those MS that wish to work more closely together on certain matters to do so, while respecting the single institutional framework of the Union. The MS concerned can use the enhanced cooperation procedure to move forward without the participation of all MS where common action under the regular provisions of the Treaty is not possible. Its principles are laid down in the Treaty on European Union (art 40-45)⁶² and there are detailed procedures for its application in the EC Treaty (art. 11-11a).

At least eight Member States must be involved to initiate enhanced cooperation, but it remains open to any Member State that wishes to participate to join later. Enhanced cooperation must also further the Treaty objectives and respect the whole of the *acquis* Communautaire and the rights and obligations of non-participating Member States. It may not undermine the internal market or apply to an area that falls within the exclusive competence of the Community.

⁶⁰ Based on *Europa Glossary* http://europa.eu/scadplus/glossary/index_en.htm

⁶¹ Presidency Conclusions - Lisbon European Council 23 and 24 March 2000. Available at http://ue.eu.int/ueDocs/cms_Data/docs/pressdata/en/ec/00100-r1.en0.htm

⁶² Consolidated version of the Treaty on European Union. Official Journal C 115 of 9 May 2008 – See <http://eur-lex.europa.eu/JOHtml.do?uri=OJ:C:2008:115:SOM:EN:HTML>

Enhanced cooperation may be undertaken only as a last resort, when it has been established within the Council that the objectives of such cooperation cannot be attained within a reasonable period by applying the relevant provisions of the Treaties. The MS that wish to undertake enhanced cooperation must obtain prior authorisation from the Council, acting by a qualified majority. The Council can act only on a Commission proposal, so the interested MS must request the Commission to submit a proposal, but cannot compel it to do so.

Examples: the provisions on enhanced cooperation have not been used until now. However, similar forms of closer cooperation between subgroups of Member States have already been applied in some areas such as the Schengen process and the EURO zone⁶³

The issue of a wider fiscal reform and its interaction with ETR: The expression ‘Environmental Fiscal Reform (EFR)’ refers to a broader concept that includes reform of environmentally harmful subsidies. Although it is not within the scope of this questionnaire to look at other economic tools, one should be aware of their implications/interactions with taxes when making assumptions in the long term future.

For instance, a broader fiscal reform is likely to include, beside taxes and subsidies, other economic tools that can play a significant role, also in terms of revenue raised. This is particularly the case of auctioning of carbon allowances in the context of the EU Emission Trading System (ETS), which will play an increasing role and, arguably, it could represent a substantial source of revenue in the future. A key issue then will be how these revenues will be used – i.e. for domestic purposes (e.g. reduction of other taxes), or for international policies (e.g. technology transfer, adaptation). This discussion will become increasingly important during the next years. Another key area would be fines and liabilities. These could also play a significant role in future environmental policy.

ETR hence should be seen as part of a wider package, together with ETS, to contribute to the internalisation of externalities and the application of the ‘Polluter Pays Principle’, and avoid or reduce possible carbon leakage. EFR can be seen as covering the whole set of associated instruments – taxes, charges, subsidies, tradable permits et al.

We will really appreciate your views and comments on the issues highlighted above. The questionnaire is meant to help guiding your comments, we would appreciate if you could respond to as many questions as possible.

⁶³ Enhanced cooperation: *From theory to practice* (p. 97-119), in EPC, Egmont & CEPS: The Treaty of Lisbon: Implementing the Institutional Innovations; November 2007

Questions to experts, NGOs and EU and international institutions⁶⁴

Future policies and scenarios

1. In a European future with decreased population and increasing ageing population, the labour tax basis will likely not be as stable a resource as today. Furthermore, with the likely need to reduce greenhouse gases emission by 50-85% in 2050 (on the basis of IPCC estimates⁶⁵) and pressing environmental related problems, such as resource scarcity (living within one planet's resources) and their related price increase (e.g. oil prices), increasing pollution and the need for increased energy security, the environment will become an increasingly crucial issue.
 - Will environmental taxes and charges be a tool of critical importance to help face these challenges?
 - What do you think an appropriate balance of different taxes could be - on labour, capital, consumption – and, within consumption, environmental taxes and charges? For example, would a doubling of the current rate of environmental taxes (from 7 percent to 14-15 percent of tax revenues) by 2050 be feasible and/or advisable? Would further increases be possible? (see for examples figure 1 above)
 - To what extent could Environmental Tax Reform (ETR) help address the challenges in the following areas (e.g. from marginal help to major help) now and in the future? Where are they proved to be easier or more difficult to implement? For each area, which specific taxes and charges will be important/look more promising?
 - To address climate change (mitigation and adaptation)
 - To influence energy policy (e.g. use of renewable sources)
 - To reduce the impacts on biodiversity and ecosystem
 - To improve air and water quality,
 - To address resource scarcity (e.g. fish, water) and sustainable consumption/production
 - Others?
2. The focus of ETR is mainly on taxes and charges, but when considering its role and potential, especially in terms of revenue rising, one should also take into consideration the interaction with the auctioning of carbon emission trading allowances.

⁶⁴ Some of the questions sent to MS officers and business federations were formulated slightly differently, but covered the same issues

⁶⁵ IPCC Fourth Assessment Report, Working Group III

How will the EU ETS likely affect the potential for tax reform? What could a possible combined contribution to GDP of environmental taxes and ETS auctioned allowances be?

3. As mentioned in the introduction above, ETR has advantages and disadvantages. Environmental taxes proved to work well in some countries, less well in others, and in general have been supported by some experts and policy makers as well as opposed by others. For instance, the discussion around a carbon tax at EU level has led to little result, while other market-based instruments such as ETS have been preferred.
What do you think are today the main pros and cons of moving towards a more radical ETR? What can be learned from past lessons?
4. In order to overcome barriers to ETR (e.g. the perceived damage to competitiveness and low income population, a potential shrinking/unreliable tax base, the strong lobby from opponents) several measures and arguments have been brought forward, such as careful design of ETR, gradual introduction (including early announcement), extensive consultation, information (e.g. on best practices) and awareness raising, improved understanding of externalities and economic/environmental implications, development as part of policy packages, removal of perverse subsidies, introduction of temporary exemptions and careful evaluation measures.
Which of the existing arguments to overcome barriers for a radical ETR seem less convincing, and what other arguments could be more effective?
5. Thinking backward (see figure 1 above), in order to achieve more ambitious ETR in the long run, what should be ideally achieved by 2020 - in the EU or in some specific MS? What could be achieved in practice (i.e. realistic in light of political opposition) – e.g. in terms of type and proportion of environmental taxes and adequate mix of consumption, labour and capital taxes?
6. What could be done in the short run – e.g. in the next 5 years?
7. Are environmental taxes likely to be a permanent tool or rather a transient instrument to achieve the gradual decarbonisation of the economy and the move to resource efficiency within ‘one-planet’ bounds?

Acceptability of ETR

8. From your experience, what Member States (MS) and economic sectors have been more in favour, what more opposed to ETR?
9. It is often argued that it is usually ‘losers’ that mobilise against ETR, while ‘winners’ are less aware of the benefits and therefore less active in campaigning in favour of ETR. Can this imbalance be addressed, and if so, how?

10. What approach should be used to achieve greater harmonisation across the EU in the field of ETR (e.g. Open Method of Coordination - OMC, enhanced cooperation – see table 1 and box 1 above) – what level of flexibility should be left to MS?
11. Enhanced cooperation can only be initiated if there is a formal agreement within the Council that a certain issue (in this case, environmental taxation) cannot be addressed by applying EU normal legislative procedures. This process can be lengthy, and also implies a formal recognition of EU institutional ‘failure’, which could be politically sensitive. Would you be in favour of making enhanced cooperation clauses more flexible, e.g. in order to avoid the need to establish ‘failure’? Would such a change be feasible and politically acceptable?
12. Enhanced cooperation requires the close collaboration of at least 8 MS. If such an approach should be pursued to improve harmonisation, which MS do you believe would be the most suitable participants?
13. What are the main messages that should be communicated to increase ETR societal acceptance and minimise political opposition from Member States? Which have worked/not worked in the past?
14. How can higher environmental taxes be justified in case of high oil prices (e.g. alleviation measures, specific use of revenues etc)?

Please send your replies to Samuela Bassi sbassi@ieep.eu – or contact me by phone at 0044 (0)207 340 2685

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Annex II – QUESTIONNAIRE RESPONSE FROM THE EUROPEAN COMMISSION’S DIRECTORATE GENERAL FOR TAXATION AND CUSTOMS UNION (DG TAXUD)

This annex includes one of the questionnaire responses, namely the official response from the European Commission’s Directorate General for Taxation and Customs Union (DG Taxud) which was received on the 19th of May 2009.

Future policies and scenarios

1. In a European future with decreased population and increasing ageing population, the labour tax basis will likely not be as stable a resource as today. Furthermore, with the likely need to reduce greenhouse gases emission by 50-85% in 2050 (on the basis of IPCC estimates⁶⁶) and pressing environmental related problems, such as resource scarcity (living within one planet’s resources) and their related price increase (e.g. oil prices), increasing pollution and the need for increased energy security, the environment will become an increasingly crucial issue.
 - Will environmental taxes and charges be a tool of critical importance to help face these challenges?

TAXUD answer:

The picture outlined shows some of the challenges and possible opportunities that tax systems face or are likely to face. To complete the picture, the concept of globalisation should be added. The interaction between all these phenomena can be quite complex, but, in principle, environmental taxes can potentially play a positive role in addressing these challenges.

Due to globalisation and the high mobility of factors such as capital, related sources of revenue have become more vulnerable and less suitable, thus favouring tax shifts towards less mobile sources such as consumption and labour. But labour as a tax base will inevitably shrink with an ageing population, thus shifting taxes further towards consumption.

Ambitious environmental objectives and emphasis on cost-effectiveness can create a natural incentive for a more extensive use of environmental taxation and possibly a shift in tax revenue. In this context, tax reform might be a useful means for an ageing society to maintain revenue and preserve sustainable public finance in times when the traditional tax base becomes more vulnerable on the one hand and spending requirements are likely to grow on the other (pension and health care). However, a narrower labour tax base will not allow for a shift in the tax burden in the traditional job-creating sense.

⁶⁶ IPCC Fourth Assessment Report, Working Group III

Environmental taxes and charges also reduce the need for green subsidies and public spending on green issues, thus contributing positively to sustainable public finance in the new context.

The attractiveness of environmental taxes or other instruments as a potential future tax, however, also has some possible drawbacks, in particular:

- *A partially mobile tax base: as long as the EU remains largely isolated in its environmental efforts (to the extent that they increase costs for business) such taxes risk shifting capital outside the EU, in the same way as capital taxes. However with changes in attitude towards environmental protection around the globe, such a disadvantage might easily disappear.*
- *A possibly disappearing tax base: it is often claimed in taxation circles that if effective, tax revenue from environmental taxes will decline since the environmentally-damaging tax base will disappear. Apart from prohibitively high taxes without a real revenue generating role (e.g. the Irish plastic bag tax), such a problem has not occurred so far, but in the future tax bases might decline with the gradual shift towards cleaner energy sources. However, even in such a case energy taxes would still be needed to achieve various policy objectives, i.e. tax as a means to stabilise energy prices (cf. question 14) or as a price incentive to encourage energy efficiency. These objectives make sense even for clean energies, since all energy is scarce and needs to be consumed as efficiently as possible). It is, however, open to discuss how such taxes on clean energy shall be called (cf. the definition of environmental tax).*
 - *What do you think an appropriate balance of different taxes could be - on labour, capital, consumption – and, within consumption, environmental taxes and charges? For example, would a doubling of the current rate of environmental taxes (from 7 percent to 14-15 percent of tax revenues) by 2050 be feasible and/or advisable? Would further increases be possible? (see for examples figure 1 above)*

TAXUD answer:

This is hard to say. The share of environmental taxes in overall tax revenue depends on several issues, in particular on:

- *The share of other taxes in total tax revenue: (the lower the share of other taxes in total revenue (e.g. due to recession), the higher the share of environmental taxes (which might be less open to cyclical changes).*
- *The definitions used. The widely-used Eurostat/TAXUD indicators include genuine tax revenues, thus excluding for example revenue raised by road user charges (revenue hypothecated on the transport sector) or revenue from auctioning of ETS allowances.*
- *Policy justification. Given that environmental taxes largely need policy justification, numerical targets alone do not make much sense if they are not underpinned by real needs and externalities in the environmental area. Moreover, increasing use of other environmental instruments (such as*

environmentally-related road charging or emission trading) either reduces the maximum potential share of environmental taxes in total tax revenues or requires that revenue from the alternative instruments is also included in the figures.

- To what extent could Environmental Tax Reform (ETR) help address the challenges in the following areas (e.g. from marginal help to major help) now and in the future? Where are they proved to be easier or more difficult to implement? For each area, which specific taxes and charges will be important/look more promising?
 - To address climate change (mitigation and adaptation)
 - To influence energy policy (e.g. use of renewable sources)
 - To reduce the impacts on biodiversity and ecosystem
 - To improve air and water quality,
 - To address resource scarcity (e.g. fish, water) and sustainable consumption/production
 - Others?

TAXUD answer:

There is scope for more extensive use of market-based instruments in all the above mentioned areas. However, the instrument must not necessarily in all cases generate revenue available for an environmental tax reform. For example charges can be used to help recover costs related to the provision of certain goods or services, thus reducing the need for public funding (e.g. of water infrastructures, etc.), but not creating any revenue freely available for the public budget.

As far as the EU is concerned, the Community can take action (and even introduce common instruments) when there is a cross-border problem at stake or when potential distortions on the internal market require common action.

2. The focus of ETR is mainly on taxes and charges, but when considering its role and potential, especially in terms of revenue rising, one should also take into consideration the interaction with the auctioning of carbon emission trading allowances.
How will the EU ETS likely affect the potential for tax reform? What could a possible combined contribution to GDP of environmental taxes and ETS auctioned allowances be?

TAXUD answer:

Such a distinction is questionable. Any instrument that generates revenue that is freely available to the public budget, allows, in principle, for environmental tax reform. That is also why, in the recent years, discussions about environmental instruments and possible environmental tax reforms have referred to market-based instruments, instead of just taxes.

Charges in the strict sense of the term are the least suitable tool for an environmental tax reform because they do not generate revenue that would be freely available to the public budget for the simple reason that they serve to recover costs within a certain sector. At most, charges can serve to reduce public spending in the sector concerned, thus, eventually, contributing to an environmental fiscal reform in a broader sense.

A trading scheme with auctioned allowances, on the contrary, does not differ from a tax. Given the wide coverage of the EU emission trading scheme, with increased use of auctioning, EU ETS has the potential to generate substantial revenue and thus to increase the share of revenue from environmentally-related tax base. Such revenue would be largely (but not exclusively) additional to the existing revenue from environmental taxes, because so far, EU ETS mainly focused on sectors that are not taxable because they mainly use energy as raw material.

For the period after 2013, the Commission has estimated in its impact assessment (SEC (2008) 85, Vol. II) that under full auctioning, revenue from ETS could generate annually revenue up to 0.5% GDP⁶⁷. The Ministries of Finance have already had the opportunity to take a position on the issue by stressing that revenue should be freely available to the public budget and should not be earmarked for environmental purposes (cf. the statement of the ECOFIN Council 12/2/2008 (Press Release 6187/08)).

Emission trading removes the justification for environmental taxes having the same purpose and coverage overlapping instruments do not improve the environmental outcome of the policy and would only make the achievement of the environmental objective more costly). In consequence, emission trading with auctioned allowances replaces the revenue raising potential of environmental taxes. Thus, any discussion about environmental tax reform in Europe should either include the revenue from EU ETS or else the figures mentioned in these discussions should be reduced to take into account of the more limited tax base left for genuine tax instruments.

Moreover, the EU 2020 targets and the need to achieve them in a cost-effective way create a case for environmental taxes in the sectors not covered by the EU ETS, such as transport, households and business not included in the EU ETS. These non-ETS sectors represent about half of the EU GHG emissions. These needs also increase the scope for ETR in the EU.

Finally, when it comes to the potential of EU ETS for an environmental tax reform, apart from sharing the same advantages and disadvantages of environmental taxes (cf. question 1), there are two additional aspects that might slightly reduce the suitability of revenue from emission trading for tax reform purposes:

- *emission trading generates less reliable revenue stream due to greater volatility in the levels of revenue (linked to volatility in the price of allowances),*
- *revenue from emission trading is more prone to earmarking.*

⁶⁷ Under certain price assumptions; given the final set-up of the new ETS Directive, the extent of auctioning until 2020 will be much less.

3. As mentioned in the introduction above, ETR has advantages and disadvantages. Environmental taxes proved to work well in some countries, less well in others, and in general have been supported by some experts and policy makers as well as opposed by others. For instance, the discussion around a carbon tax at EU level has led to little result, while other market-based instruments such as ETS have been preferred.

What do you think are today the main pros and cons of moving towards a more radical ETR? What can be learned from past lessons?

TAXUD answer:

A "radical environmental tax reform" should not be an objective in itself. It is something that could follow from "radical environmental policy" (something that either exists already or will need to be introduced if we really want to safeguard the long-term survival of our civilisation). In principle, there has never been more suitable opportunity to do this than the present. Improving the environment by using market-based instruments and undertaking a tax reform could facilitate economic recovery, secure tax revenue and help to move the economy in the right direction. On the other hand, aspects such as ageing population (which allows for a shift in tax revenue, but not in the tax burden) or a wider use of non-tax instruments for environmental purposes might make such move more difficult.

In a nutshell, a "radical environmental tax reform" would require:

- *ambitious objectives that can justify an environment-related tax base (either only in place or soon to be in place),*
- *an environment-related revenue stream available to the government (this will require close co-operation between Ministries of Environment and Finance),*
- *steps by Ministries of Finance to use such revenue to reform the tax structure/public finance.*

In principle it is irrelevant whether tax or some other instrument is used in this context. What matters in the ETR context is whether or not revenue is generated for general budget. Past EU experience has shown that ETR can bring forth substantial economic and distributional benefits, as also shown by the results of the COMETR project, which examined the impacts of environmental tax reforms in six EU member States⁶⁸. Thus, the ability to generate revenue is an important aspect of an environmental instrument. It is the very idea of ETR that will make environmental policies and instruments more publically acceptable, because it allows Governments to compensate to those social groups who would face higher costs due to the policy. ETR, therefore, can be seen as a means to diminish adverse distributional consequences of the policy. Past experience has also shown that although the logic underpinning environmental policy making may be shared by society as a whole, when it comes to paying the bill, compensatory measures are indispensable. The best way of doing this depends on the particularities of each country and also on the actual design of its tax system. Reducing labour taxes works in countries where

⁶⁸See the final report in the following address: <http://www2.dmu.dk/cometr/>

labour taxes are high, but it is not suitable for the developing world, for example. Policy responses also differ depending on the composition of the economy (high share of energy intensive sectors, high share of labour intensive sectors, openness to trade towards other EU countries, openness to trade towards exterior). A very good social security net is generally required to deal with the regressive aspects of taxes on heating. The absence of this might make the taxation of household heating impossible.

4. In order to overcome barriers to ETR (e.g. the perceived damage to competitiveness and low income population, a potential shrinking and unreliable, the strong lobby from opponents) several measures and arguments have been brought forward, such as careful design of ETR, gradual introduction (including early announcement), extensive consultation, information (e.g. on best practices) and awareness raising, improved understanding of externalities and economic/environmental implications, development as part of policy packages, removal of perverse subsidies, introduction of temporary exemptions and careful evaluation measures.

Which of the existing arguments to overcome barriers for a radical ETR seem less convincing, and what other arguments could be more effective?

TAXUD answer:

Ambitious environmental objectives always entail costs, whatever instrument is used to pursue them.

Revenue recycling can be used, however, to diminish welfare costs of environmental taxation (as a result of the environmental policy put in place) and compensate to those social groups hit the hardest by cost increases. In this sense ETR is a useful and recommendable policy and the Member States should be made aware of their benefits. This is also in accordance with the conclusions of the Communication on European values in the globalised world, Contribution of the Commission to the October Meeting of Heads of State and Government, which suggest a shift of the tax burden from labour to consumption and/or pollution taxes as a part of the strategy to increase employment⁶⁹. Obstacles may occur because environmental policy will create new winners and losers despite attempts to neutralise distributional impacts. In addition, the benefits of revenue recycling might be less visible and obvious than the costs the consumers and businesses need to pay (higher price of energy affects directly all consumers, whereas reduced social security charges benefit only those who actually pay them and might be hidden in the overall liability of the company). Moreover, tax systems are in evolution. An increase in environmental taxes accompanied by a decrease in labour charges might be "spoiled" later on by new increases in labour charges as a result of social policy developments. However, for business, such a step should suffice as an argument against any Government policy of this type and environmental tax reform (even though such social policy developments would have happened anyway).

⁶⁹ COM (2005) 525 final.

5. Thinking backward (see figure 1 above), in order to achieve more ambitious ETR in the long run, what should be ideally achieved by 2020 - in the EU or in some specific MS? What could be achieved in practice (i.e. realistic in light of political opposition) – e.g. in terms of type and proportion of environmental taxes and adequate mix of consumption, labour and capital taxes?

TAXUD answer:

ETR cannot be an objective on its own. The ambitious 2020 targets of the EU and the fact that they were proposed assuming the use of cost-efficient instruments imply that there is scope and need for wider and more extensive use of environmental taxation or other market-based instruments. Moreover, the 2020 targets are only a beginning and more will need to be done afterwards. The share of environmental taxes in total tax revenue will thus depend (apart from the actual revenue from other taxes) on the extent to which taxes or other revenue generating market-based instruments are used to facilitate meeting policy objectives and also on the extent to which revenue from such instrument is freely available to Finance Ministries (which might less be the case should market-based instruments other than taxes be used more widely).

In one way, environmental tax reform is a possible win-win option both for Ministries of Finance and Ministries of Environment. It allows the securing of a future tax base for the former (subject to the few caveats mentioned earlier) and reduces the costs of policy making for the latter.

6. What could be done in the short run – e.g. in the next 5 years?

TAXUD answer:

In the short run it will be crucial to work on the instruments design so that effective measures can be put in place with the new post-Kyoto framework. This can potentially increase the revenue from environmentally-related tax base, most likely from 2013.

7. Are environmental taxes likely to be a permanent tool or rather a transient instrument to achieve the gradual decarbonisation of the economy and the move to resource efficiency within ‘one-planet’ bounds?

TAXUD answer:

It is generally considered that once environment-related instruments achieve their objective, the justification for them disappears. As long as any environmentally-damaging tax base exists, environmental taxes can be levied to internalise external costs. Afterwards they are needed to stabilise energy prices or to incentivise energy efficiency (even clean energy sources have to be consumed with caution)

Acceptability of ETR

8. From your experience, what Member States (MS) and economic sectors have been more in favour, what more opposed to ETR?

TAXUD answer:

Member States – those Member States traditionally in favour have been those with a strong environmental commitment.

Economic sectors - most opposition traditionally has come from those affected: the polluters (sectors that directly feel the price increase related to internalisation of costs borne by the society beforehand).

9. It is often argued that it is usually ‘losers’ that mobilise against ETR, while ‘winners’ are less aware of the benefits and therefore less active in campaigning in favour of ETR. Can this imbalance be addressed, and if so, how?

TAXUD answer:

This is probably because the costs are more visible than the benefits. To address such imbalances, there should be more emphasis on the benefits of the policy and the instrument and also on the social costs of inaction. The stronger the environmental justification, its endorsement by society and the broader the geographical reach of the environmental policy, the weaker the ability of ‘losers’ to block efforts.

10. What approach should be used to achieve greater harmonisation across the EU in the field of ETR (e.g. Open Method of Coordination - OMC, enhanced cooperation – see table 1 and box 1 above) – what level of flexibility should be left to MS?

TAXUD answer:

It is not evident that ‘greater harmonisation across the EU in the field of ETR’ would be either needed or desirable.

In the case of environmental taxation, differentiated tax rates often reflect different environmental policies (or different fiscal needs). Commonly shared goals mean a common need to take measures to achieve them, thus higher costs for all concerned and less distortions of competition. Common goals might favour the use of similar or common instruments internationally and might require common instruments or a common minimum degree of harmonisation within the EU (from an internal market and/or efficiency point of view). We cannot expect our trading partners to adopt our instruments until they share goals to our own. Similarly it cannot be justified to impose instruments across the EU without all Member States sharing the same goals. Differences in levels of environmental taxes generally reflect two things: differences in the environmental ambition of Member States (and/or their fiscal needs) and their willingness to use tax as an instrument. Thus, initiatives in favour of environmental taxes should concentrate on the justification for using taxes as an instrument of

environmental policy and should respect the environmental ambitions of Member States. In cases where such an ambition is set at EU level, requirements on EU-wide instruments must respect these ambitions. EU-wide targets on renewables have largely helped to develop similar policy instruments. On the contrary, the emission targets under Kyoto were largely differentiated based on the level of development of EU Member States and this distinction (kept also for the post-2012 period and introduced also in the renewables area) means that EU environmental tax harmonisation cannot go beyond what is necessary EU-wide commonly for all Member States.

When it comes to environmental tax reform, the EU has no competence. It has not been demonstrated so far that common action in this area would be needed or justified. Different Member States have different needs and different structures in their tax systems. There is no single way that Member States should restructure their tax systems. It remains in the competence of the Member States how they would use the tax revenues and in what way they would structure their tax system. In this respect no single recipe exists. But the Member States can be made aware of the benefits of ETR as an economically efficient way to promote environmental policy objectives. .

11. Enhanced cooperation can only be initiated if there is a formal agreement within the Council that a certain issue (in this case, environmental taxation) cannot be addressed by applying EU normal legislative procedures. This process can be lengthy, and also implies a formal recognition of EU institutional 'failure', which could be politically sensitive. Would you be in favour of making enhanced cooperation clauses more flexible, e.g. in order to avoid the need to establish 'failure'? Would such a change be feasible and politically acceptable?

TAXUD answer:

Firstly, it is not clear what kind of benefit similar arrangements would bring and what kind of practical need calls for them. The Commission carried out a broad public consultation on the use of market-based instruments for environmental and other purposes⁷⁰. The consultation did not show that there would be an imminent need for tax harmonisation in a particular environmental area where no tax harmonisation exists and where views differ so much to require enhanced co-operation.

Secondly, in those areas where environmental tax legislation already exists (in particular taxation of energy), the scope for similar action is very limited. Existing Community legislation can only be amended by means of Community legislation. In the energy tax area the structures of taxes are fully harmonised and thus the only scope for limited action would be in the area of rates. Should tax differences create distortions on the internal market or should the minimum levels of taxation no longer reflect underlying policies, then, the Community should adapt its taxation rules.

⁷⁰ The summary of the responses is available for example under this link: http://ec.europa.eu/taxation_customs/common/consultations/tax/index_en.htm

Potentially a group of Member States could co-operate closer when setting their rates. But such co-operation might be politically rather sensitive.

12. Enhanced cooperation requires the close collaboration of at least 8 MS. If such an approach should be pursued to improve harmonisation, which MS do you believe would be the most suitable participants?

TAXUD answer:

Enhanced co-operation cannot improve existing tax harmonisation. Community legislation can only be improved by means of a new Community act. Member States are of course free to co-operate as they wish (although we have not come across any initiative of that kind), but in area where harmonised legislation exists their activities cannot clash with the harmonised rules.

More in general and more importantly, the EU is currently trying to convince its main partners in the world to take commitment on climate change. It is not clear how would the outlined initiatives fit within that framework and how would they strengthen the EU negotiating position.

13. What are the main messages that should be communicated to increase ETR societal acceptance and minimise political opposition from Member States? Which have worked/not worked in the past?

TAXUD answer:

Cf. above. ETR can hardly be an objective in itself. ETR makes environmental measures more acceptable and is a possible means for cost-effective environmental policy making. Environmentally-related taxes can be attractive both for Finance and Environmental ministries. However, there must be a policy justification for such use of taxes. Thus, campaigns in favour of environmental taxes should concentrate on promoting and explaining their benefits in the context of the underlying policies. The ambition of such policies might differ at EU level and nationally. Although there might be very good reasons for EU action in the field of environmental instruments, such action cannot go beyond the commonly shared environmental goals.

14. How can higher environmental taxes be justified in case of high oil prices (e.g. alleviation measures, specific use of revenues etc)?

TAXUD answer:

It is true that high energy prices might make existing energy tax policies more vulnerable and new ones more difficult to introduce. In general they increase the pressure on the logic and the justification behind energy tax policies.

- Existing policies: As long as energy tax policies do not create unjustified distortions, high energy prices do not require changes in existing energy tax

policies. Energy taxes are an important price stabilising factor, thus mitigating the impact of high, low or volatile prices of primary energy on consumers and ensuring more constant price signal. The 2008 oil price hike had the strongest impact on sheltered sectors, such as aviation, shipping and fishing.

- New policies: Energy taxes can be justified as long as they support wider policy objectives. In particular, high energy prices cannot substitute taxes as instrument to internalise environmental costs, because increase in energy prices does not create the same incentive as a targeted CO₂ instrument would. It is however true that the combined effect of the increased price of primary energy and the tax instrument will likely be bigger and thus the level of the tax and related externality might be lower due to overall lower energy consumption when energy prices are high.