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NOTE

From: General Secretariat of the Council
To: Permanent Representatives Committee/Council

Subject: Greening the European Semester: environmentally harmful subsidies and implementation of environmental legislation
- Exchange of views

In the framework of the activities related to Greening the EU Semester, the (Environment) Council adopted in October 2014 a set of conclusions ¹ on how to facilitate a transition to a more sustainable, low carbon and resource efficient economy with a view to the "Annual Growth Survey 2015" to be presented in November 2014.

The "Annual Growth Survey 2016", expected in November 2015, will be the start of the next EU Semester cycle. In this context, the Presidency considers that there is a need to reflect further on ways and means to ensure that the environment dimension continues to play a full role, together with the economic and social dimensions, in this process.

¹ "Greening the EU Semester and the Europe 2020 Strategy - Mid-term review", 28 October 2014 (14731/14).

In particular, the Presidency proposes to focus the debate at the forthcoming (Environment) Council on two key issues, namely, (1) the phasing out of environmentally-harmful subsidies and (2) the implementation of environmental policies and legislation.

In order to guide the exchange of views in Council the Presidency has prepared a background paper and four questions (in Annex). Discussions will be subsequently summarized in the joint synthesis report to the General Affairs Council with a view to the European Council in March 2016.

The Committee of Permanent Representatives is invited to take note of the questions drafted by the Presidency in Annex and forward them to Council for the above-mentioned exchange of views on 26 October 2015.

Harmful Subsidies, European Semester & Better Implementation

This paper gives background for a discussion on one of the key topics in the context of greening the European Semester - the phasing out of environmentally harmful subsidies -, presents the state of play on greening the European Semester, and last but not least proposes opening a strategic and structured discussion on common causes and good practices of tackling implementation gaps of existing environmental law and policies.

Sustainable development policy aims to achieve a continuous improvement in citizens' quality of life and well-being. This involves the pursuit of economic progress, while safeguarding the natural environment and promoting social justice as well as inter-generational equity, thus ensuring that the needs of the current population are met without compromising the perspectives of future generations. The economic, environmental and social dimensions are all part of the EU's annual cycle of economic governance, the European Semester. The European Semester is a key process for ensuring that Member States return to higher growth levels; it identifies complementarities between economic and environmental challenges in a way that highlights the opportunities for new sources of economic growth.

Phasing out of environmentally harmful subsidies (as part of an environmental fiscal reform) has been identified as one of those opportunities. The fact that, currently, fiscal consolidation is a top priority in many Member States creates an opportunity to accelerate the reform: to increase public revenues, and at the same time to achieve efficiency gains and environmental benefits. Some Member States have successfully implemented recommendations put forward in this area; good practices exist and can easily be followed. But they can only work if a level playing field is ensured across the EU by also closing the implementation gap of the key environmental obligations.

1. Phasing out environmentally-harmful subsidies

Policy context

The detrimental effects of environmentally-harmful subsidies (EHS) have been on the political agenda for a number of years. The EU has repeatedly committed itself to their gradual phase-out in recent years, for instance in the Europe 2020 Strategy, as an important element of the green growth agenda. While some efforts to map such subsidies have been carried out, progress has however been slow and they remain an important pressure for the environment in most EU countries.

The most recent commitment includes the 7th EAP ¹, which requires that environmentally harmful subsidies are phased out without delay at Union and Member State level.

The Europe 2020 strategy includes, within its Resource Efficient Europe ² flagship initiative, a call on Member States "to phase out environmentally harmful subsidies, limiting exceptions to people with social needs". To do so, in the Roadmap to a Resource-efficient Europe ³, Member States were called upon to identify the most significant EHS, prepare plans and timetables to phase out EHS and report on these as part of their National Reform Programmes in the context of the European Semester.

¹ Decision No 1386/2013/EU of the European Parliament and of the Council of 20 November 2013 on a General Union Environment Action Programme to 2020 "Living well, within the limits of our planet".

² COM(2011) 21 final.

³ COM(2011) 571 final.

The call to avoid or reform environmentally-harmful subsidies also figures in a number of specific policy initiatives. This includes the reforms of the Common Agricultural and Fisheries Policies and the new Cohesion Policy instruments. Given their distortive effects on the internal market, the Commission's recently modernised State aid rules also call for a phasing out of subsidies that are environmentally-harmful or leading to inefficient resource use. This general principle has been translated into more concrete provisions, in particular the revised Guidelines on State aid for environmental protection and energy ⁴, which entered into force in July 2014. The provisions of those guidelines apply to all sectors, including agriculture and forestry, for which also specific State-aid guidelines exist.

The European Council of 22 May 2013 concluded that to facilitate investments, priority will be given to phasing out environmentally or economically harmful subsidies, including for fossil fuels; the October 2014 Environment Council pointed at phasing out of environmentally harmful subsidies as one of the instruments to smooth a transition to a more sustainable low carbon and resource efficient economy.

The European Parliament adopted a resolution on 26 November 2014 ⁵ which calls "on the Commission and the Member States to adopt without delay concrete measures for progressively phasing out all environmentally harmful subsidies by 2020, including subsidies on fossil fuels, guided by the Commission, using an action-based approach and monitoring via the European Semester."

⁴ Communication from the Commission "Guidelines on State aid for environmental protection and energy 2014-2020" (2014/C 200/01).

⁵ Resolution on the 2014 UN Climate Change Conference – COP 20 in Lima, Peru (1-12 December 2014), 2014/2777(RSP).

The activities at EU level should also be seen in the context of related international initiatives. The leaders of the G-7 declared at their 2014 annual Summit that they remained committed to the elimination of inefficient fossil fuel subsidies (FFS) and encouraged all countries to follow ⁶. The G-20 has since 2009 advocated a FFS phase out in the "medium term" and set up a peer-review system on progress towards this objective. EHS commitments have also been made within the framework of global environmental governance (the Rio+20 Outcome Document reiterates commitments to addressing trade distorting subsidies and harmful subsidies in the fisheries and fossil fuels sector). In September 2015, UN Member States adopted the new Sustainable Development Goals setting an ambitious and universally applicable agenda to 2030. This includes a commitment to work towards phasing out subsidies harmful to the environment and specifically to fisheries. EHS phase out also figures in a number of specific multilateral environmental agreements, e.g. Aichi Target 3 under the Convention on Biological Diversity, aimed at eliminating, phasing out, or reforming 'incentives, including subsidies, harmful to biodiversity' by 2020.

The case against EHS and specific sectoral challenges

Providing a subsidy to a product or service on the market will generally have a distorting effect, unless it is introduced to correct an externality, another market failure or a service of public interest. Beneficiaries of the subsidy will increase their demand for the product, other sectors of the economy will face a lower demand and the overall efficiency will fall. This can stimulate the excessive and wasteful use of natural resources. With producer subsidies, costs of production are lowered, production is increased or sustained for those who produce "on the margin" and companies have fewer incentives to innovate.

EHS can therefore lock us into inefficient practices and business structures, lead to policy inconsistencies, and hinder investment in greener technologies or practices. Therefore, they delay the transition towards a more resource-efficient low-carbon economy and undermine EU environmental objectives and, as regards FFS, energy and climate ones.

⁶ http://europa.eu/rapid/press-release_MEMO-14-402_en.htm.

Finally, EHS benefiting specific sectors or social groups are often inefficient from a social policy perspective. As they are often provided in the form of lower tax rates, rebates or exemptions with respect to VAT and excise taxes, poor households for example benefit less from tax rebates on energy than rich ones. International Energy Agency analysis indicates the poorest 20% of the population only receive 8% of the money spent on FFS; other direct forms of welfare support would cost much less.

Agricultural subsidies pose a particular challenge. Farmers manage half the land in the EU, and agricultural activity is by its very nature intimately involved with soil, water, air, landscape and biodiversity; it is therefore much harder to separate agricultural activity from environmental impacts than it is for industrial activities. Moreover, aid to productive investments in agriculture can often become environmentally harmful, leading to wasteful use of those natural resources and encouraging unsustainable intensification of production; and in turn resulting in a degradation of the natural resource-base agriculture relies on (e.g. through soil depletion, biodiversity loss, water scarcity or water pollution from overuse of pesticides or fertilisers) and thence undermining the sector's long-term viability. Successive reforms of the Common Agricultural Policy (CAP) largely delinked payments from production, so reducing the environmental pressures from the subsidies; but new possibilities for linking subsidies to production were introduced in the recent CAP reform as well as a high degree of flexibility for Member States to define eligibility criteria for funding. Care will be needed to ensure that this does not lead to increased environmental pressure. A connected issue is the integration of agricultural and environmental policies. Here, a recent report by the European Court of Auditors ⁷ finds that the EU has been only partially successful in integrating water policy goals into the CAP and that modifications to the current instruments (cross-compliance and rural development) are necessary to ensure such integration.

⁷ ECA special report (No 4/2014) “Integration of EU water policy objectives with the CAP: a partial success” http://www.eca.europa.eu/Lists/ECADocuments/SR14_04/SR14_04_EN.pdf.

Fisheries subsidies can also threaten the very sustainability of fisheries resources by encouraging overcapacity and excess fishing effort, thus reducing the long-term viability of the fishing industry. However, successive reforms of the Common Fisheries Policy, in particular the latest, have made significant contributions to redirecting EU fisheries subsidies towards more environmentally sustainable spending.

The magnitude of the issue

In spite of many policy declarations, actual progress on the ground in EHS phasing-out has been very slow, not only at EU level, but also in Member States and in the other OECD countries.

The most researched EHS are subsidies to fossil fuels production and use. The IMF estimates that at a global level, on a post-tax basis, they were worth USD 1.9 trillion worldwide in 2011 or 2½ percent of global GDP or 8 percent of total government revenues. At EU-level, FFS are also of a significant scale – for the then EU 27 Member States budgetary support and tax expenditures to fossil fuel reached EUR 25.2 billion in 2011 ⁸, recent OECD report ⁹ shows that support to fossil fuels went down; this decline is attributed both to the recent decrease in oil prices and policy reforms. Another form of a subsidy is the preferable tax treatment of company cars and commuting expenses. The total revenue loss caused by the former in the 17 Member States that are also OECD members reached EUR 21 billion in 2012 ¹⁰.

⁸ OECD (2013), "Inventory of Estimated Budgetary Support and Tax Expenditures for Fossil Fuels 2013"; Oosterhuis F., et al., (IVM, 2013), "Budgetary support and tax expenditures for fossil fuels. An inventory for six non-OECD EU countries", Final Report to DG Environment, the European Commission. The OECD figure reflects the OECD's conservative approach which excludes some types of grants or tax reductions as well as concessionary loans or guarantees.

⁹ OECD (2015), OECD Companion to the Inventory of Support Measures for Fossil Fuels 2015, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264239616-en>.

¹⁰ Harding, M. (2014), "Personal Tax Treatment of Company Cars and Commuting Expenses: Estimating the Fiscal and Environmental Costs", OECD Taxation Working Papers, No. 20, OECD Publishing. <http://dx.doi.org/10.1787/5jz14cg1s7vl-en>.

Payments to agriculture account for the largest part of EU budgetary spending. The European Agricultural Fund for Rural Development (EAFRD) is also a significant source of funding for environmental measures related to biodiversity, soil, and water in Member States. The new Rural Development Programmes (for the period 2015-2020) therefore have a key role to play to increase the level of environmental spending and go as far as possible in excluding funding for practices that are environmentally harmful. Beyond CAP funding, subsidies to agriculture such as preferential price schemes for water used for irrigation (a measure in place in many water scarce countries, leading to the expansion of irrigated land and excessive use of an increasingly scarce resource) or granting of tax exemptions to tractor fuel ("red diesel") or lower registration taxes for vehicles used in farming, are very detrimental and widespread.

Approaches to EHS reform – the way forward

All Member States recognise the need to eliminate EHS, but often run into difficulties – usually because of strong resistance from those that stand to lose the most. Experience shows that the critical precondition for a reform is transparency, consultation and communication in order to win broad-based support for the decisions that are required. Identification of the beneficiaries of a subsidy and an assessment of the scale and impact of an existing subsidy, both in terms of its effectiveness and efficiency will demonstrate whether the subsidy is still relevant and will detect priorities for the reform.

Many successful examples of EHS reform are seen in Member States where EHS reform has been introduced as part of a broader package of instruments including policies to mitigate adverse impacts of subsidy removal. Introducing a transition period is a common solution, gradual phase out of a subsidy can be complemented by compensating those affected by the reform, ensuring that potential negative impacts on household affordability and well-being are mitigated through targeted schemes (e.g. means-tested social safety net programmes).

The distribution of benefits and costs of the proposed reform is key. Experience shows that reforms sparks off less controversy if the generated funds are redirected to priority areas such as healthcare, education or lowering labour taxes.

2. State of play greening the European Semester

As agreed with the ‘trio’ partners, the Presidency considers it opportune to continue the discussion on ‘greening’ the EU’s annual cycle of economic governance, the European Semester. The Semester concentrates on macro-economic challenges and therefore includes an environmental dimension, such as environmental taxation and removal of EHS. The analytical Semester **Country Reports** 2015 (adopted in February) contain various references to how the environment contributes to the jobs and growth agenda, and seems to have been appreciated in many Member States as a good basis for discussions with stakeholders, and as trigger for greening the **National Reform Programmes** (NRPs) ¹¹.

Compared to 2014 and before, the Semester **Country Specific Recommendations** (CSRs) 2015 are limited in number and concentrate on specific macroeconomic and labour market reforms. However, the CSRs of 2014 (which contained recommendations on environmental fiscal reform and/or harmful subsidies for 10 Member States) are still valid, as far as they have not yet been implemented. It is expected that the Country Reports will retain a more comprehensive approach in 2016, including environmental references and policy reform orientations, whereas the CSRs might remain targeted on economic and social development.

In order to achieve progress, the CSRs within the EU Semester process need to be followed up. In fact one of the key findings which led to its focusing in 2015 was that more attention and follow up must be given by the Member States to the **implementation** of the Semester CSRs, including those which remained unaddressed from the past years.

¹¹ Conclusions from exchanges in the Expert Group Greening the Semester on 07.09.2015.

The European Semester remains a key process for orienting the major reforms allowing the EU and its Member States to improve their competitive edge, and enables the cooperation between public authorities – at the EU and national level – in shaping policies with this aim. It is one of the means to **mainstream and integrate environmental concerns** in other relevant policies, in line with the approach defined by Article 11 TFEU. Therefore, ‘greening the European Semester’ remains an important process.

The first deliverable of the 2016 European Semester will be the **Annual Growth Survey** (AGS, adoption expected in November 2015), which will contain guidance for the priorities in the 2016 NRPs. A key point of consideration for the AGS will be in what way the Sustainable Development Goals (**SDGs**) and the upcoming ambitious Commission **Circular Economy** (CE) Package will be reflected. Both policy frameworks reflect the need to move to a new economic model. An AGS with a ‘business as usual’ approach to the EU’s economic governance could put the implementation of the SDGs and the CE package at risk.

3. **Better implementation**

It is clear that the implementation of the relevant recommendations made in the EU Semester process such as those relating to waste and water management or environmental taxation will benefit not only growth and jobs but also the environment as such. However there is more we could do in the Environment Council than overseeing these recommendations. The EU has a well-developed environment policy with a rather complete and mature legal framework. Protecting the environment and maintaining our competitiveness can go hand-in-hand, and environment policy also plays a key role in creating jobs and stimulating investment. In many fields covered by the EU environmental *acquis*, as well as by agreed environmental policies (e.g. 7th EAP), there are sometimes large **implementation gaps**, with **substantial differences** between individual Member States ¹².

¹² Sources include the State of the Environment 2015 by the European Environment Agency, national reporting on environmental requirements, Eurostat data and other studies.

Member States experiences in implementing the EU environmental policies and legislation - both successes and problems - are as important as the adoption of legislation or policies for the credibility and effectiveness of environmental policies in the eyes of EU citizens and businesses. On the other hand, enforcement alone, although indispensable, is not enough or suitable to address implementation gaps and their root-causes. Enforcement should be a last resort.

The environmental policies the Council is called to design, as well as the legislation on which it will co-legislate, can only benefit from the political consideration of our experiences. One welcomed contribution, in this respect, is Commission's **shift** in focus from making new legislation **to improving implementation**, including on exploring options to solve implementation gaps beyond the legal instruments (e.g. using softer approaches like capacity building, voluntary agreements, education and information, and economic instruments).

Bearing in mind the evolution and prospects of the European Semester process and of the increased emphasis on implementation, there is scope to **discuss at ministerial level** periodically the main outstanding **environmental implementation gaps**, and the reasons for them; what kind of solutions and opportunities could be envisaged; what best practices exist and can be shared; and how tailored-made support could be given where needed. This would also have the advantage of addressing at political level opportunities and challenges by other policy areas such as agriculture, transport, energy.

By an exchange of good implementation practices, the Council could also address common systemic challenges and their causes across the EU Member States and explore possible solutions at a political level.

Although implementation of environmental *acquis* and policies as such is the responsibility of the Member States, implementation gaps have often **cross-border effects** or impinge on the competitive level playing field for important economic operators and therefore could be discussed as ‘horizontal’ topic at political level in the Council rather than only at technical level. An example, by no means the only or necessarily the most urgent, of a possible horizontal topic is the implementation of water pricing requirements. Where Member States have a different level of implementation, this results in absence of a **level playing field** for businesses or for whole economic sectors, in addition to environmental damage.

Common and therefore **‘horizontal’ causes of weak implementation**, often across environmental sectors, include shortcomings in administrative capacities; lack of enforcement; under-investment; lack of policy coherence and consistency; inflexibility of implementation arrangements; insufficient knowledge; sub-optimal planning procedures, and insufficient involvement of relevant actors. Certainly enforcement at EU level is required in many instances, but often there are other solutions which could have a deeper impact if steered at the appropriate level. Such instruments to improve implementation include (financial) incentives; voluntary agreements; stimulating behavioural change; exchange of experiences and peer support; developing targeted knowledge; training and education; improving the administrative capacity.

During recent informal exchanges of views between Member States and Commission officials it was deemed useful to address the outstanding gaps in the implementation of the current policies and *acquis* in a more strategic way, including through ministerial debates in the Council. This should be followed by actions to tackle them, including transfers of good practices between Member States and support from the Commission.

4. Questions for the debate

The Presidency proposes to focus the discussion on the following **questions**:

On environmentally harmful subsidies:

1. *What are the **barriers** to phasing out of harmful subsidies and how can they be or have been overcome or in your country? What factors (e.g. transitional measures, increased transparency/publicity about beneficiaries, innovative schemes, governance of interface with special interest groups) and what interest groups in your experience are drivers for successful EHS reform?*
2. *How can EHS reform be better integrated into broader EU efforts to promote competitiveness, growth and employment and through which instruments? Can better regulation and the promotion of greater **policy coherence** be drivers of EHS reform? What is the experience in your country?*

On greening the Semester and improving environmental implementation:

3. *Do you think that the change towards a new economic model based on a **circular economy** and inspired by the universally applicable Sustainable Development Goals (SDGs) needs to be reflected in the **Annual Growth Survey 2016** and in future years?*
4. *Taking account of experience in implementing policies and legislation, would it be useful to start **structured strategic policy discussions** in the Council about the underlying causes of outstanding and common **systemic implementation gaps** on the acquis and on agreed policies, based on analysis of such gaps?*
