Environmental policies and economic performance

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A dirty, rundown environment has quantifiable costs for the economy and the well-being of societies. For example, the welfare costs of air pollution from road transport alone are estimated to amount to around USD 1.7 trillion in OECD countries, USD 1.4 trillion in China and USD 0.5 trillion in India. Without adequate policy action, costs will continue to increase, and can have tangible effects on economic growth, for instance through reduced labour productivity. Similarly, the prospects for long-term growth are under stress – for example, climate change is projected to decrease global GDP by 1% to 3.3% by 2060.

These are of course, but a microcosm of all the environmental challenges we face. Yet, action to address environmental pressures often proceeds too slowly. Policy makers have long feared that stringent environmental policies may constrain competitiveness and growth. For example, a number of studies attributed a significant part of the 1970s productivity slowdown in the United States to the tightening of environmental policies. Such fears also underlie the so-called Pollution Haven Hypothesis, which sees a flight of industrial activity and pollution leakage to countries with laxer environmental standards. Moreover, arguments against tightening of environmental policies have re-emerged in the context of an increasingly globalised world with fragmented production and mobile capital.

At the same time, there are solid indications that the future is not necessarily a race to the bottom and that environmental protection and growth are not an “either-or” dilemma. A counter argument is that more stringent environmental policies will encourage changes in behaviour by firms and households, reduce inefficiencies, and encourage the development and adoption of new technologies that may be good for the environment, and for the economy as well. After all, growth did not collapse following the implementation of numerous environmental policies over the years. Moreover, when scrutinised, the claims of negative effects of environmental policies have found little backup in the data.

Empirical evidence from the OECD clarifies this. Based on analysis of two decades of data on the stringency of a subset of environmental policies and economic outcomes in 24
OECD countries, it shows that productivity has generally not been negatively affected by the introduction of more stringent environmental policies. Yes, there have been some temporary adjustments, but these tend to disappear within a couple of years.

To be clear, there will be winners and losers. The most productive and technologically advanced firms (and industries) tend to actually gain from tighter environmental policies, an outcome likely reflecting their superior ability to grasp the new opportunities by innovating and improving their products, but also potentially by relocating part of their production abroad. In contrast, the least productive firms – which generally use their resources less efficiently – may see a temporary fall in their productivity growth, possibly as they require more investments to cope with the more stringent environmental requirements. Some of the least productive firms may cease to operate. Still, if resources are swiftly reallocated to young and expanding firms, the overall impacts will not necessarily be negative and can be positive, both for the economy and the environment, particularly if policies are put in place to enable the entry and exit of firms into and out of markets and to support employment.

Follow-up work on international trade and environmental policies adds another perspective to this picture. Taking a global value chain perspective on the Pollution Haven Hypothesis, OECD work finds some confirmation of the hypothesis itself. However, there is no overall loss of competitiveness of economies attributable to environmental policies. More stringent environmental policies do have significant effects on comparative advantages – countries with more stringent policies tend to lose competitive edge in more pollution-intensive activities. However, this loss is compensated by a gain in less pollution-intensive activities – hence, an overall shift in specialisation patterns. Still, while significant, the effects are very small, for instance with respect to those of trade liberalisation. They are in line with other recent evidence on competitiveness effects and on the potential of affecting countries’ specialisation in so-called environmental products – a rapidly expanding global market. Increased trade in such products can spur global improvements in environmental quality. In fact, when combined with stringent, well-designed environmental policies, open trade can form a vital
channel for reducing pollution and spurring growth both globally and domestically.

Economic dynamism and flexibility are crucial to ensure such positive outcomes, and the design of environmental policies can do a lot to contribute. The keywords are flexibility and competition: market-based instruments, such as green taxes, that leave the choice to the firm as to which clean technology to use, tend to have more robust positive effects on productivity. On the contrary, while rules to spur markets are important, policies that lead to excessive and unnecessary “green tape” or provide advantages to incumbents, such as laxer norms or subsidies that prop up dirty and inefficient firms, can prevent both environmental and economic progress. One of the crucial findings of recent work is that in general there is no correlation between the stringency of environmental policies in OECD countries and the regulatory burdens they impose. In other words, more stringent environmental policies can be designed while limiting the burdens such policies may impose.

Finally, countries can also do much more to align policies across many different areas, such as taxation, investment, land-use or sectoral policies, to be more consistent with environmental goals. Obviously, this is not easy, and more work linking the environment, environmental policies and economic outcomes is on the way.

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