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7. Environmental Contracts: A Flemish Law and Economics Perspective

Michael Faure

1 WHY CONTRACTS?

Many chapters in this book deal with the American experience concerning environmental contracts.[1] They not only provide an interesting overview and classification of the various types of contracts that have been used in the US, but also address the theoretical framework within which one must examine these environmental contracts. In that respect, a lot of attention is paid to the important question of whether environmental contracts should be considered as regulation or as contracts. If one reads these chapters carefully, it becomes clear that environmental contracts have so far not been very popular in the US, though many of the authors believe that there is room for an increased use of these contracts.[2] Indeed, the frequency of rising environmental contracts seems to be an important difference between the US and Europe, especially Belgium and the Netherlands, where environmental contracts have become relatively popular.[3]

1.1 Advantages

From an environmental policy perspective, the first question which must inevitably be addressed is obviously: Why should a regulator choose to use environmental contracts at all? A naive lawyer (or, some would argue, a smart one) could argue that if the government believes that a certain subject in

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[1] See, e.g., the chapter in this book by Geoffrey Hazard and Eric Orts.

[2] For a similar conclusion, see J. Davidson, "Voluntary Agreements in the USA" in J. van Dunné (ed.), *Non-Point Source River Pollution: The Case of the River Meuse* (Kluwer Law International, London, 1996), pp. 217–230.

[3] For an overview of the use of environmental agreements in Europe with a description of recent studies, see ELNI (ed.), *Environmental Agreements. The Role and Effect of Environmental Agreements in Environmental Policies* (Cameron May 1998); P. Bailey, "The Creation and Enforcement of Environmental Agreements" (1999) Eur Envtl L Rev 170.

environmental policy merits regulation, then that is precisely what the government should do: take responsibility and regulate, using the full array of command-and-control or economic instruments that have been described in the literature.[4] Why would it be better in some cases to negotiate with the regulated industry, resulting in the "reg negs"[5]? Many arguments are advanced traditionally in the literature to favor environmental contracts, including environmental contracts are consensus based; they emphasize pollution prevention rather than clean up; they allow for regulatory flexibility in light of changes in scientific knowledge; and they offer the opportunity of fruitful, collaborative decision making.

One could also approach environmental contracts in light of economic analysis of law.[6] On one hand, a law and economics scholar should be enthusiastic hearing the idea that, for example, optimal abatement techniques or standards would be fixed as a result of voluntary agreements between government and industry. One would be tempted to think that this may result in a optimal allocation of resources as predicted by Ronald Coase.[7] However, Coase's theory obviously applies primarily to negotiations between victims and polluters, and the government can hardly be considered as a representative of victims in a Coasean bargaining framework. One might counter that if a government intervention in environmental policy is deemed necessary, for instance because of prohibitive transaction costs, it would be wiser from an economic point of view to look primarily to market-based instruments, such as emission trading systems rather than direct regulations, even in the form of "environmental contracts." Still, an economist could respond that if the government regulates environmental standards, the result is likely to be more efficient when the government negotiates with industry. At least in theory, the advantage of this bargaining process would be that the often poorly informed government would obtain adequate information about the environmental risks involved and about the abatement techniques to reduce those risks.[8] The resulting regulation would be nicely tailored to the specific situation of industry and would thus "mimic" a market solution. This approach to environmental regulation may therefore prove better than command-and-control regulations that are simply imposed upon the regulated community. Command-and-control regulation always entails the risk of the government imposing regulatory standards without conducting a proper cost-benefit analysis.[9]

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4 For a recent survey of the available instruments for pollution control see N. Gunningham and P. Grabosky, *Smart Regulation. Designing Environmental Policy* (Clarendon Press, Oxford, 1998).

5 See the terminology used by Hazard and Orts in their chapter.

6 See the chapters collected in Part III of this book.

7 R. Coase, "The Problem of Social Cost" (1960) JL & Econ 1.

8 In the words of Gunningham and Grabosky: "Voluntarism has the considerable virtue of being non-interventionist, having high industry acceptability and raising minimal equity concerns." Gunningham and Grabosky, supra note 4, at 58–59.

9 On the importance of cost-benefit analysis for regulatory appraisal, see generally A. Ogus, "Regulatory Appraisal: A Neglected Opportunity for Law and Economics" (1998) Eur JL & Econ 53. On the regulation of risk in particular, see A. Ogus, "Risk Management and 'Rational Social Regulation'" in R. Baldwin (ed.), *Law and Uncertainty: Risks and Legal Processes* (Kluwer Law International, London, 1997), pp. 139–153.

1.2 Dangers

Although the idea of a regulation that results from free negotiations with market participants sounds very appealing at first glance, the major danger is obviously that it could result in a regulation of the kind in which the contents are simply determined by industry. In that case, environmental contracts would be nothing but another technique for industry to lobby for lenient environmental standards.[10] Indeed, industry could behave strategically in its negotiations with a government agency when it comes to providing adequate information on the environmental risks at stake and the possibilities for reducing them. Industry's incentives for disclosing such information during negotiations of environmental contracts may well be very limited, especially when this information could be used to impose extra costs on industry. Naturally, this risk of regulatory capture is recognized in the literature on environmental agreements.[11] When discussing environmental contracts, one will inevitably have to address the question of how one can avoid the risk of these so-called public choice effects. Neglecting this danger would run the risk that an environmental contract would simply result in the nightmare of institutionalized capture rather than the wonderful fairy tale of market-based voluntary compliance. The question therefore arises whether it is possible to construct a framework to encourage an environmental policy that enjoys the advantages of negotiated contracts without the disadvantages of administrative capture.

2 A LEGAL FRAMEWORK

One possible way to enjoy the undoubtedly existing benefits of environmental contracts and to limit the inherent risks is to adopt legislation that would identify the kinds of cases in which the government may use environmental contracts. This type of legislation, indicating the conditions under which a regulator could waive specific regulatory requirements, would clearly establish the limits and potential benefits of environmental contracts for all market participants.[12] In considering such legislation, the US could benefit from European experience. For example, a Draft Decree on Environmental Policy prepared in the Flemish region of Belgium by an Interuniversity Commission for the Reform of Environmental Law sets forth strict criteria concerning the use of environmental covenants.[13]

In 1989, the former Flemish minister for environmental policy installed a commission of academics, under the presidency of Hubert Bocken, and

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[10] See generally M. Maloney and R. McCormick, "A Positive Theory of Environmental Quality Regulation" (1982) JL & Econ 99; J. Adler, "Rent Seeking Behind the Green Curtain" (1996) *Regulation* 26.

[11] See Hazard and Orts, supra note 1.

[12] See P. Gilhuis, *Milieurecht op weg naar de jaren negentig* (W.E.J. Tjeenk Willink, Zwolle, 1989), pp. 22–28.

[13] The text of this draft is included in an appendix to this chapter.

asked it to draft a comprehensive code on environmental law and policy.[14] The first report of this commission was presented in December 1991,[15] and the final draft was presented in 1995.[16]

Many parts of this Draft Decree, including the chapter on environmental agreements have now been implemented in the Flemish legislation.[17] Indeed, even before the Interuniversity Commission presented its final draft, the Flemish authorities had implemented the proposals of the commission in 1994.[18] In the remainder of this chapter, I will primarily discuss the text of the Draft Decree and indicate where the provisions can be found in a good English translation.

The Flemish (Draft) Decree contains several interesting provisions. Article 4.7.2, for example, states that environmental covenants cannot replace existing legislation or regulations and cannot depart from their general terms.[19] Such a legislative framework seems useful and necessary in order to make the rules of the game explicit both for the government and for the contracting partners.[20]

The Draft Decree also contains a few other provisions which are worth mentioning. One crucial issue is to make clear who has representative power for industry to negotiate an environmental contract. Another is to indicate whether the contract has binding force upon an entire industry. One difference between a contract and regulation is that contracts, in principle, only bind the parties, whereas regulations may be enforced upon all those for whom they apply.[21] This obviously raises the question of the representative force of an industry organization that agrees to a regulatory contract. In Flanders, the Flemish government may conclude the environmental agreement with one or more umbrella organizations that represent enterprises faced with a common environmental problem.[22] In principle, the

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[14] See Besluit van de Vlaamse Executieve van 5 juli 1989 houdende Oprichting van een Interuniversitaire Commissie tot Herziening van het Milieurecht in het Vlaamse Gewest, *BS*, 25 August 1989.

[15] See H. Bocken and P. Verbeek (eds), *Voorontwerp decreet milieuhygiene*, Seminarie voor Milieurecht, 1991.

[16] Interuniversitaire Commissie tot Herziening van het Milieurecht in het Vlaamse Gewest, *Voorontwerp Decreet Milieubeleid*, Bruges, Die Keure, 1995, also available in English: H. Bocken and D. Ryckbost (eds), *Codification of Environmental Law. Draft Decree on Environmental Policy* (Kluwer Law International, London, 1996), pp. 2–158. For an outline, see H. Bocken, et al., "The Flemish Draft Decree on Environmental Policy: An Outline" in H. Bocken and D. Ryckbost (eds), *Codification of Environmental Law. Proceedings of the International Conference* (Kluwer Law International, London, 1996), pp. 11–40.

[17] For an overview, see K. Deketelaere, "Belgium" in R. Seerden and M. Heldeweg (eds), *Comparative Environmental Law in Europe. An Introduction to Public Environmental Law in the EU Member States* (Maklu, Antwerp, 1996), p. 38.

[18] Decree concerning environmental contracts of 15 June 1994, *Moniteur Belge*, 8 July 1994.

[19] Article 3 of the Decree of 15 June 1994.

[20] For a discussion of the framework for environmental agreements in this Flemish Draft Decree, see H. Bocken, et al., "The Flemish Draft Decree on Environmental Policy: An Outline," supra note 16, at 22, and K. Deketelaere and M. Faure, "Environmental Law in Belgium" in N. Koeman (ed.), *Environmental Law in Europe* (Kluwer Law International, The Hague, 1999), p. 76.

[21] See Hazard and Orts, supra note 1.

[22] Article 4.7.1 of the Draft Decree; Article 2 of the Decree of 15 June 1994.

agreement binds only the members of that particular organization, but this approach runs the risk of non-members acting as free riders.[23] It hardly seems effective to supplement a covenant with command-and-control regulation in order to exclude free riding. In that case, many of the advantages of using covenants would disappear. To remedy some of these problems, the Flemish regulation on environmental covenants stipulates that the region shall be empowered to convert an environmental covenant, either wholly or in parts, into regulations, even during the period that the covenants are applicable. Thus the covenant in fact becomes transformed into a regulation, a process which confirms that the difference between covenants and regulations may not be as large as one might first expect. In any case, it is certainly important to guarantee the representative qualities of an industrial or branch organization in order to prevent a covenant from creating an artificial barrier to entry.[24] This may occur if certain standards had been negotiated with the government to which only a particular branch of industry could comply, thus enabling this group to drive their competitors out of the market.

3 BINDING FORCE?

The issue of binding force, which is crucial in any contract, not only plays a role for the representative branch organization, but also for the governments who negotiate with industry. The "reg negs" have apparently not been very popular in the United States, and one reason may be that these types of negotiated agreements have not resulted in a contract that is enforceable against the government. If the government agency is free to withdraw from the agreements, the question then arises what incentives industry would have to conclude the agreement with the government in the first place. A contract which is only binding for one party can hardly be considered a contract. In the American context, this problem has apparently been remedied to some extent through the *Winstar* doctrine which prevents the government from easily changing its mind on a contract made in regulatory context.[25]

The European experience indeed shows that these types of environmental agreements will only be successful if the result of the negotiations are somehow binding for the government. Again, referring to the Flemish example, Article 4.7.4 of the Draft Decree clearly states that environmental covenants shall be legally binding on the parties.[26] Moreover, Article 4.7.3 states that during the applicable period of an environmental covenant, the

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[23] On this free riding risk, see N. Gunningham and P. Grabosky, supra note 4, at 433.

[24] On the use of standards to erect barriers to entry, see R. Hahn, "The Political Economy of Environmental Regulation: Towards a Unifying Framework" (1990) *Public Choice* 21; A. Ogus, *Regulation, Legal Form and Economic Theory* (Clarendon Press, Oxford, 1994), pp. 55–75.

[25] See Hazard and Orts, supra note 1.

[26] Article 5 of the Decree of 15 June 1994.

Flemish Region shall not issue any regulation imposing more stringent requirements than those in the covenant. Furthermore, Article 4.7.4 stipulates that environmental covenants shall be binding not only for the parties, but also for all members of the organization. Environmental covenants in Flanders are therefore binding in principle for a certain period, but they can be terminated. A termination is possible with six months notice or through common agreement between the parties.[27]

4 ENFORCEMENT

A major problem with environmental contracts is how the covenant can be enforced. Public prosecutors in Europe generally do not like these types of self-control mechanisms in environmental law, because they fear that they cannot easily monitor compliance.[28] In Flanders, this problem is to some extent solved because environmental agreements cannot depart from existing regulations. The covenant itself is also binding for members of the organization that have concluded the covenant, but the Flemish Draft Decree is silent about how compliance shall be monitored. It does stipulate, however, that where provisions of an environmental covenant are infringed, any party who is bound by it may claim specific performance or damages from the person who has committed the violation.[29] Thus, the Flemish Draft Decree clearly provides for remedies of a contractual sort. It is, again, in the best interest of all parties to the contract that members of a representative branch organization comply in order to exclude free riders.

Obviously, public law remedies such as fines do not apply in the case of violation of a contract. This kind of remedy is available only when the government has converted the contents of the covenant into a regulation. Then the covenant can be enforced by means of public law. Again, this process indicates that there is in fact only a thin line between a covenant and a regulation. The government must be careful that covenants do not simply turn into regulations whereby industry has the luxury of determining the contents of regulation for itself.

5 TRANSPARENCY

It is also important to address the transparency of the procedure through which covenants are drafted. In this respect, it is important to publicize any proposed discussions about a project agreement with interested parties, including providing motive to community and public interest groups. It is

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27 Articles 4.7.8 and 4.7.10 of the Draft Decree; Articles 9 and 11 of the Decree of 15 June 1994.

28 See, e.g., A. de Lange, "Trias Politica in de Polder" (1998) *Nederlands Juristenblad* 866.

29 Article 4.7.9 of the Draft Decree; Article 10§2 of the Decree of 15 June 1994.

important to guarantee notice and participation rights to third parties precisely in order to avoid the risk of regulatory capture. The Flemish Draft Decree provides for the publication of a draft of any environmental covenant and for mandatory consultation with the public at large.[30] At the same time, if the same guarantees of public involvement in standard setting and licensing procedures are extended to environmental contracts, then many of the advantages of speedy decision-making and flexibility may soon disappear. Again, this demonstrates that if one wishes to give a covenant the same qualities as regulation, such as a binding force upon third parties and public rights of participation, the differences with regulations become smaller.

6 TRANSBOUNDRY CONTRACTS

There is perhaps one field where there might be a great deal of room for environmental agreements, namely the area of transboundry pollution. Many of these covenants or treaties do exist, and some law and economics scholars such as Cohen and van den Bergh, for example,[31] see the application of the Coase theorem to apply even more directly in this context of transboundry pollution. But though it is certainly true to say that some of these covenants which have been concluded sound like fairy tales,[32] it is equally true to state that they would probably never have come into being without the support of institutional arrangements such as the European Directives issued in the framework of European environmental law. The incentives to agree to a covenant would not have been as great if there had not been the threat of regulation under European environmental law, which might even have been a factor for a non-Member state such as Switzerland. Although no formal enforcement of European law is possible against Switzerland, the Swiss compliance with the *acquis communautaire* seems important. Another interesting example is the river contract of 1996, concerning the upper-Meuse which is, however, confined to the Belgian territory. Some skeptics contest the effectiveness of this non-binding instrument, since it remains closely linked to the existing command-and-control instruments, and the environmental results are poor when one considers the time and money expended.[33]

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30 Article 4.7.5; Article 6 of the Decree of 15 June 1994.

31 M. Cohen, "Commentary" in E. Eide and R. van den Bergh (eds), *Law and Economics of the Environment* (Juridisk Forlag, Oslo, 1996), pp. 67–171; R. van den Bergh, *Economics in a Legal Strait-Jacket: The Difficult Reception of Economic Analysis in European Law*, paper presented at the workshop Empirical Research and Legal Realism. Setting the Agenda, Haifa, 6–9 June 1999.

32 For the case of the river Rhine, see J. van Dunné (ed.), *Transboundary Pollution and Liability: The Case of the River Rhine* (Lelystad, Vermande, 1991).

33 See D. Misonne, "The River Contract of the Upper-Meuse," in ELNI, *Environmental Agreements* (Cameron May, 1998), pp. 25–26.

7 NEED FOR EMPIRICAL RESEARCH

This chapter will finally address the importance of empirical research in this area. The first results seem promising: several Dutch scholars have compared the efficiency of environmental covenants with the results achieved under market-based instruments and they are, once more, relatively enthusiastic concerning environmental covenants.[34] One of their conclusions is that the likelihood of compliance with the terms of a covenant is higher if, during the application period of the covenant, the government guarantees that it will not intervene with more stringent measures, such as the adoption of new taxes. Industry thus complies if they can achieve some gain by doing so. Still, scholars conclude that in comparison, market-based instruments such as tradeable pollution rights, may be more efficient than environmental contracts. In addition, the Rhine covenant seems to be an example of a success story for environmental agreements.

A study of the use of environmental agreements in many European countries performed by the Environmental Law Network International (ELNI) recommended, on the basis of empirical research, the use of environmental agreements to complement the weaknesses of existing environmental policy tools. According to this study, environmental contracts work best in combination with other policy instruments.[35] Therefore, ELNI recommends further research on the effects of different combinations of instruments.[36] On the basis of this future empirical research, one might finally be able to judge the usefulness of the environmental contracts.

In addition, there are some basic legal questions that remain to be examined. In the European context, one must question whether the increasing use of environmental contracts by Member States is compatible with the requirement that European directives should be implemented by clear and enforceable legislation. However, a tendency towards the increasing use of European-wide covenants is also perceptible.[37] The future use of environmental contracts largely depends upon these experiences.

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[34] See R. Wit, et al., *Kosten en baten van milieuconvenanten in vergelijking met marktconforme instrumenten* (Ministerie van Economische Zaken, The Hague, 1999).

[35] The same conclusion is reached by N. Gunningham and P. Grabosky, supra note 4, at 432–433.

[36] ELNI, supra note 3 at 163–170.

[37] See ibid., which contains a discussion of the Commission Communication on Environmental Agreements of 1996.

ANNEX: FLEMISH DRAFT DECREE ON ENVIRONMENTAL POLICY

Title 7 Environmental Covenants

Article 4.7.1

For the purpose of applying this title, the term "environmental covenant" shall be understood as meaning an agreement concluded between, on the one hand, the Flemish Region, represented by the Flemish Government—hereinafter referred to as The Region—and, on the other hand, one or more umbrella organizations—hereinafter referred to as The Organization—having legal personality and representing enterprises which either operate in the same field of business or are faced with a common environmental problem, or are located in the same area, for the purpose of preventing environmental pollution, limiting or removing the consequences thereof, or of promoting effective management of the environment.

Article 4.7.2

Environmental covenants can not replace the existing legislation or regulations nor depart from them in a less strict sense.

Article 4.7.3

§1 During the period of applicability of the environmental covenant, the Region shall not issue any regulations imposing by means of an Executive Decision, in relation to subjects dealt with by the covenant, more stringent requirements than the latter. However, the Region shall remain entitled to adopt measures or issue regulations, both in cases of urgency, and in order to meet obligations imposed by the international law or European law. The Region shall be empowered to convert an environmental covenant, either wholly or in part, into regulations, even during the period of applicability of the covenant.

§2 Environmental covenants can not reduce nor limit the authority of any other public body.

Article 4.7.4

Environmental covenants shall be binding on the parties. Depending on the clauses contained in them, they shall also be binding on all the members of the organization or on a group of its members, to be defined in general terms.

Article 4.7.5

§1 A summary of the draft environmental covenant shall, on the initiative of the Region, be published in the Official Journal or in any other medium designated for that purpose. This summary shall at least describe the subject-matter and the general purpose of the

environmental covenant. The full proposed version of the draft covenant shall be available for consultation for a period of thirty days in a place to be stated in the published version of the agreement.

§2 Within a period of thirty days of the date on which the summary was published, any person may submit his objections and observations in writing to the competent departments of the Flemish Government, designated for that purpose in the published summary. These departments shall examine the objections and observations submitted and transmit them to the Organization.

§3 The draft environmental covenant shall be communicated to the Flemish Social and Economic Council and to the Flemish Council for the Environment and Nature, who shall issue a properly reasoned opinion within a time limit of thirty days following the date of receipt of the draft. This opinion shall not be binding.
Where one of the aforementioned advisory organs issues a negative opinion on the draft, the Region shall, in a report to be added to the published version referred to in §5, justify its decision nevertheless to conclude the covenant.

§4 Where the draft environmental covenant is amended in the light of the objections or opinions submitted, the agreement may be concluded without there being any need to initiate once again the procedure described in §1 to §3.

§5 Environmental covenants shall, following their signature by the parties, be published in full in the Official Journal, where appropriate preceded by the report referred to in §3.

§6 Save where express provision has been made to the contrary, environmental covenants shall enter into effect ten days after the date of publication thereof in the Official Journal.

Article 4.7.6

Only where the region and the organization give their consent may an organization of enterprises which meets the condition set out in Article 4.7.1, accede to an environmental covenant, in accordance with the procedure to be determined by a decision of the Flemish Government. Any such accession shall be published in the Official Journal. As from the date of the notification, the environmental covenant in question shall be binding on the acceding organization. Depending on the relevant clauses of the deed of accession, the agreement shall also be binding on all the members of the acceding organization or on a group of its members defined in general terms. By virtue of its accession, the acceding organization shall become a party to the covenant.

Article 4.7.7

§1 Environmental covenants shall be concluded for a certain period. Save where express provision has been made to the contrary, this period shall be two years. No environmental covenant may be extended tacitly.

§2 The Region, as well as one or more of the affiliated organizations, may extend the validity of an environmental covenant in unamended

form. The Region shall, at least two months prior to the expiry of applicability, propose any such extension to the advisory bodies referred to in Article 4.7.5

§3 The latter shall submit their opinion within a time limit of thirty days. This opinion shall not be binding. Where one of the aforementioned advisory bodies submits a negative opinion on the extension of an environmental covenant, the Region shall, in a report to be added to the published version of the extension, justify its decision nevertheless to proceed to extend the covenant. Any extension of an environmental covenant shall be published in the Official Journal, where appropriate preceded by the report referred to in the previous paragraph.

§4 In the course of its period of validity, the parties may agree to amend an environmental covenant, provided that neither its contents nor its objectives be influenced thereby to any significant extent. Any such amendments shall be published in the Official Journal. They shall be binding for all the parties who where previously bound by the covenant.

Article 4.7.8

The parties may at all times terminate, subject to notice, an environmental covenant, subject to observing a period of notice of six months. Where the notice of termination is not given by the Region, it must be made jointly by the other parties. The procedure to be followed when issuing this notice of termination shall be laid down by the Flemish Government.

Article 4.7.9

Where the provisions of an environmental covenant are infringed, any party who is bound by it may claim specific performance or damages from the person committing the violation.

Article 4.7.10

Environmental covenants shall terminate either by common agreement between the parties, by the expiry of a specified period, or by notice of termination. The adaptation of regulations in accordance with Article 4.7.3 shall not have the effect of terminating the covenant.

Article 4.7.11

The parties shall report to the Flemish Parliament on the implementation of the environmental covenant. The formalities and conditions which are to be observed in making these reports shall be determined by a decision of the Flemish Government.

Article 4.7.12

The provisions of this title shall be mandatory. They shall apply to the environmental covenants which will be concluded after the entry into force of this Decree.