

# SOURCEBOOK ON ENVIRONMENTAL FUNDS IN ECONOMIES IN TRANSITION

## EXECUTIVE SUMMARY

*The Sourcebook provides information on CEE/NIS environmental funds,*

The "Sourcebook on Environmental Funds in Economies in Transition" provides basic information on 21 environmental funds in Central and Eastern Europe (CEE) and the New Independent States of the former Soviet Union (NIS).

*...a distinctive feature of environmental financing in CEE and NIS.*

Environmental funds are a distinctive feature of environmental financing in these countries with their origins in the pre-transition period. Typically, they are domestic public institutions, capitalised by "earmarked" pollution charges and fines, which disburse subsidies for environmental improvements.

*Earmarking revenues and subsidised finance are discouraged in market economies...*

Comprehensive environmental funds do not exist in OECD countries. Earmarking is discouraged as it often leads to institutional "lock-in" and inefficient use of resources. Generally, environmental policy is guided by the Polluter-Pays-Principle (PPP). The PPP provides for certain exceptions to its "no subsidy" philosophy; specifically, a subsidy may be justified if it is well-targeted, limited in size and duration and does not introduce significant distortions in markets or where considerable externalities are involved.

*... but may be justified in periods of economic transition.*

The full application of PPP in economies in transition has been constrained by a number of market and institutional failures. Though not a "first best" policy, funds can be an effective mechanism for financing environmental protection in the transition period, provided they are properly designed and operated. "The St. Petersburg Guidelines on Environmental Funds in the Transition to a Market Economy", adopted by the EAP Task Force in 1995, recommend the key principles for the administration of such funds. The criteria set forth in the St. Petersburg Guidelines have been subsequently used as a benchmark in assessing Funds' performance.

### Main Conclusions of the St. Petersburg Guidelines on Environmental Funds

- ◆ To avoid or minimise the long-term economic inefficiencies inherent in earmarking of funds, expenditure should be targeted to environmental priorities and projects with large environmental benefits relative to their costs.
- ◆ Environmental funds should play a catalytic role in financing environmental improvements and support, not compete with, emerging capital markets.
- ◆ Environmental funds should reinforce other environmental policy instruments.
- ◆ Environmental funds should develop an overall financing strategy, follow clear procedures for selecting projects in order to ensure cost-effective use of resources, adopt effective monitoring and evaluation practices, and make effective use of internal and external expertise to enhance administrative efficiency.
- ◆ Environmental funds should leverage increased private sector resources and capital market financing for environmental investments.
- ◆ In designing and evaluating fund revenue mechanisms, environmental authorities should ensure environmental effectiveness, economic and administrative efficiency, equity and acceptability.
- ◆ Environmental funds should ensure transparency and should be accountable to government, parliaments, and the public for their actions.

***Funds in CEE/NIS differ significantly in size...***

The performance of environmental funds is closely linked with overall progress of reforms in these countries. In 1997 the aggregate revenues of the eight surveyed CEE "national" funds, totalled 720 mln USD or 9.44 USD/capita. Including other environmental funds in the region, not surveyed here, would bring this figure to well over 800 mln USD. In contrast, in 1997, the eight NIS "national" funds raised about 36 mln USD or 0.16 USD/capita.

***...the support they have provided for environmental investments...***

Even within the CEE and NIS regions, funds differ significantly. The 1997 revenues of Russia's Federal Environmental Fund (~18 mln USD) exceeded the combined revenues of all other NIS national funds for that year (~17 mln USD). In 1997, the revenues of Poland's National Fund for Environmental Protection and Water Management (~ 403 mln USD) surpassed the aggregate revenues of the other CEE national funds (~317 mln).

In many countries funds have played an important role in financing environmental expenditure. In 1996, environmental funds in Poland accounted for about 33% of total environmental investment expenditure, whereas the comparable share for the funds in Hungary, Slovenia and Lithuania was about 20%. In Russia however, funds provided less than 5% of finance for environmental projects and the share was much less in other NIS countries.

***...as well as with regard to their institutional set-up and legal status.***

The institutional and legal status of Funds varies considerably across the region: from largely independent, extra-budgetary legal entities with their own institutional infrastructure, to budget lines administered by Ministry of Environment staff. The most successful funds in the region have been those where political involvement is limited to setting national priorities, key operational rules and project selection criteria, and where funds' managers are given the responsibility to select projects objectively within an agreed framework.

***Funds have enjoyed increasing revenues which have supported...***

While funds, in general, have enjoyed growing revenues in recent years, increasing the level and stability of revenue flows remains a priority for most of them. Strengthening the design, implementation and enforcement of economic instruments, upon which funds rely for the bulk of their revenues, could contribute significantly to stabilising their revenue base. Some funds could also take greater advantage of foreign sources of revenues.

***...pollution abatement investments in the CEE and non-investment activities in the NIS.***

The expenditure focus of funds varies among countries. Pollution abatement investments in the air and water sectors dominate the expenditures of most funds, particularly in CEECs. Revenues of some funds, particularly in the NIS, are too low however, to allow significant spending on capital investment projects, and are commonly allocated for non-investment activities, such as monitoring.

***Funds employ a variety of disbursement tools...***

Funds also employ a variety of disbursement mechanisms for delivering their financial support, the dominant form being grants. In a number of CEE funds, there is a growing tendency to complement grants with soft loans. Each form of subsidised finance has its advantages and disadvantages and funds should carefully consider the choice of instrument on the basis of their capacity to administer different instruments (loans are more complex than grants), the types of projects which they aim to support and the role they seek to play in the broader system of environmental finance.

***...but should support the development of more***

There is little empirical evidence that soft finance, provided by funds, is inhibiting other sources from financing environmental investments. However, anecdotal evidence

***market-based finance mechanisms.***

suggests that the risk is real, particularly where funds disburse significant amounts (e.g. Poland and the Czech Republic). This risk is likely to grow in the CEE countries engaged in EU accession. It is crucial, therefore, that funds maximise the leveraging effect of their resources and ensure that they do not compete with private sector financiers. They should aim to support the development of other, more market-based finance mechanisms.

***The EU accession poses new challenges to the CEE funds...***

In some EU accession countries, environmental funds may play a key role in financing environmental investment. They could serve as intermediaries to help channel EU financial assistance for environmental projects. One potential obstacle in this connection is compatibility of environmental funds with EU law on state aid and competition. Candidate countries will need to analyse the role of funds and be prepared to justify their existence as a necessary tool for achieving compliance with the EU regulations, and to phase them out when stated targets are achieved.

***...as do offsets and other non-monetary transactions in the NIS.***

The situation in the NIS poses a different set of challenges for the funds in those countries. In some NIS the practice of offsetting pollution charges seems to be wide spread. Offset schemes in NIS suffer from a number of critical defects, which adversely affect the stability of the entire public finance system. Such practices, as well as other non-monetary transactions conducted by funds, should be phased out as part of the effort to establish a clearer framework for environmental (and other) policies, which reduce the scope for administrative discretion, excessive negotiation and corruption.

***Funds can be effective transitional instruments but are not substitutes for effective economic and environmental policies.***

While environmental funds have helped speed the pace of environmental improvements in many countries in the transition period, they should not be seen as substitutes for fundamental reforms. They should actively support the development of more market-based mechanisms, ultimately leading to stricter, more direct implementation of the PPP. Environmental authorities should periodically review the effectiveness of Funds as policy instruments and adjust them to the evolving needs in the transition process.

To obtain a copy of the ***Sourcebook on Environmental Funds in Economies in Transition*** please send an e-mail to [nelly.petkova@oecd.org](mailto:nelly.petkova@oecd.org)

For more information about the **OECD EAP Task Force Work Programme, 1998-2000**, visit our website at: <http://www.oecd.org/env/eap> or send an Email to [env.contact@oecd.org](mailto:env.contact@oecd.org) or fax to: Fax: +33 1 4524 96 71.

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