



**ORGANISATION FOR ECONOMIC  
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**OECD GLOBAL FORUM ON SUSTAINABLE  
DEVELOPMENT**

**« CONFERENCE ON FINANCING THE  
ENVIRONMENTAL DIMENSION OF SUSTAINABLE  
DEVELOPMENT »**

**RAPPORTEURS' REPORT**

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SUSTAINABLE DEVELOPMENT**

Organised in cooperation with the World Bank and the UN Department of Economic and Social  
Affairs<sup>1</sup>  
24-26<sup>th</sup> April, 2002

**RAPPORTEURS' REPORT<sup>2</sup>**

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This was the first event organised within the framework of the newly-established OECD Global Forum on Sustainable Development. The theme of the Conference was Financing the Environmental Dimension of Sustainable Development. The meeting was organised in co-operation with the UN Department of Economic and Social Affairs and with the active involvement of the World Bank.

Within the perspective of the forthcoming World Summit on Sustainable Development that will be held in Johannesburg, South Africa, 26<sup>th</sup> August - 4<sup>th</sup> September, 2002, the main objectives of the Conference were to examine:

- The policy and political context for financing the environmental dimension of sustainable development
- How to strengthen international partnerships, particularly for achieving the Millennium Development Goals
- Policies, tools and institutions for managing public environmental expenditures
- The conditions required for effectively harnessing private financial flows for the environmental dimension of sustainable development
- Approaches for financing the urban water and sanitation sector, particularly in light of the 2001 Bonn Conference on Freshwater Resources and the goal of improving access to safe water as specified in the Millennium Declaration.

More than 200 people participated in the Conference from a range of OECD countries, emerging markets, transition economies and developing countries. From the public sector, several different policy communities were represented: development co-operation, finance and environment. The

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<sup>1</sup> Financial support provided by Sweden and the World Bank is gratefully acknowledged.

<sup>2</sup> While the report aims to summarise the key issues discussed at the Conference, it does not necessarily reflect the views of all participants or the organisers. Documentation for the Conference can be found at <http://www.oecd.org/ccnm/sustdev>.

private sector, trade unions, NGOs and academics also participated which gave the event a multi-stakeholder character. The diversity of participants stimulated a rich debate of the agenda items. It was clear that there are no simple “blueprints” for addressing these difficult issues. However the meeting identified important principles, tools and approaches that are generally applicable; the challenge is tailoring them to the circumstances in particular countries.

## **1. The road to Johannesburg**

Participants strongly supported the view that the World Summit for Sustainable Development, 26<sup>th</sup> August – 4<sup>th</sup> September 2002, Johannesburg, South Africa, presents an opportunity to address the global trends in poverty and inequality that underpin the marginalisation of the developing world by developing a concrete programme of action addressed to the economic, social and environmental objectives of sustainable development. Participants agreed that Johannesburg should build on the results of several important international meetings that have taken place over the last couple of years:

- At the Millennium Summit in New York in September 2000, Heads of State put poverty at the centre of the international debate/agenda and elaborated a set of development goals that need to underpin development cooperation. The Millennium Development Goals emphasize the multi-dimensional nature of poverty which goes beyond low income and includes lack of access to basic services such as safe water, education and health care. They also include important environmental goals. As a result there are important inter-connections within and among the Millennium Development Goals.
- The Doha conference in November 2001 agreed on measures to further liberalise trade and thereby to promote meaningful economic development. Trade Ministers agreed to place the needs of developing countries at the centre of the work of the World Trade Organisation.
- The Financing for Development Conference in Monterrey in February this year reversed the ten year decline in Official Development Assistance, and established a consensus on the financial framework for developing new, strengthened partnerships for achieving the Millennium Development Goals.

The WSSD will be a culmination of these important milestones. It is hoped that a “new deal” to eradicate poverty and inequality in a way that also protects the environment will be agreed at Johannesburg which builds on the achievements of these conferences. The Global Deal should be based on reciprocal actions by developed and developing countries and expressed through the main outcomes currently envisaged for the Johannesburg Summit. It should comprise the following key elements:

- A high-level political agreement by all governments, North and South, to create a climate that is conducive to addressing global inequality and poverty in the context of sustainable development;
- A concrete programme of action to accelerate the delivery of Agenda 21 and the Millennium Development Goals, with delivery and coordination mechanisms, resource commitments, timeframes and monitoring mechanisms
- A range of specific sectoral partnerships and actions in priority areas such as water, energy, food security, education, health and technology, and biological diversity to be delivered at the local, national, regional and international levels

The Conference discussed a range of policies, programmes and mechanisms in relation to the financing of the environmental component of sustainable development which would, in turn, support the delivery of the proposed ‘new deal’ to eradicate poverty and inequality.

## **2. The national policy context for financing the environmental dimension of sustainable development**

Participants identified a number of policy steps that all national governments could take to strengthen the financial basis for financing the environmental dimension of sustainable development:

- *Promote the implementation of the Polluter-Pays and User-Pays Principles.*

The Polluter-Pays Principle is the guiding principle in many countries for financing environmental investments. Implementing the Polluter-Pays Principle requires establishing environmental laws, regulations and instruments that internalise external environmental costs. In principle, any investment or other compliance costs should be borne by the polluter, without subsidy from the state. Governments should design and implement environmental policy instruments, including market based instruments, so as to create incentives for polluters to comply with environmental policy objectives at least cost; for example by using flexible “mixes” of instruments that encourage cost minimisation; by reducing barriers to finance and technology; by a mix of strict enforcement and compliance promotion. Incentives for potential investors are also increased when environmental requirements are clear, transparent, stable and provide a long-term framework for investment planning.

Finance is one instrument that governments can use to achieve environmental objectives, particularly to support the provision of public goods (like biodiversity) and environmentally-related infrastructure (like water supply and sanitation or waste management). However, financial resources by themselves are not always the best or most appropriate way to achieve environmental goals. If financial resources are not applied in conjunction with policy and institutional reforms, they may result in wastage and undermine the incentives for dealing with the underlying causes of environmental problems.

Environmental policies and economic instruments can also generate public financial resources; for example, by establishing pollution charges and taxes. In some OECD countries, environmentally-related taxes now account for about 7% of tax revenues, equivalent to about 2% of GDP. Further sharing of experience and best practices on these and related instruments would be beneficial.

The User-Pays Principle requires users of natural resources such as water to pay the full delivery cost. As explained below, there are important obstacles to implementing this Principle in sectors like water and electricity, and social safety nets are needed to guarantee access to these services for poor and marginalised groups. Nevertheless, there is considerable scope, for example, in capturing rents from forests more effectively (the World Bank estimates \$9 billion globally) and for charging more for environmental services (the Bank estimates that \$1-3 billion could be raised by charging visitors for access to national parks).

- *Remove perverse subsidies that are economically inefficient and environmentally and socially damaging*

Water and electricity are the sectors where there is considerable scope to remove perverse subsidies. In both cases, the subsidised price encourages excessive consumption, increases environmental pressures and undermines the financial viability of the institutions responsible for the delivery of the services. Such subsidies are often justified on the grounds that they are pro-poor. However, the evidence is to the contrary; for example, poor people not connected to piped water in some developing countries are paying 10 or 20 times the tariff rate for alternative sources of water. In such cases, the subsidies for piped water benefit the richer segments of these countries rather than the poor.

The World Bank has estimated that eliminating electricity subsidies would free up \$67 billion by reducing costs and generate \$35 billion in new revenues. In principle these resources would be available for reallocation to other priority sectors. However, removing perverse subsidies, despite the clear benefits, has proven to be politically difficult in virtually all countries. This is largely because of opposition from those groups that would lose as a result of withdrawing the subsidy. Further efforts are needed to estimate the levels and impacts of subsidies, to build political support by explaining these impacts to the public and to design transition programmes targeted on poor and vulnerable groups that may suffer from removing subsidies.

- *Promote effective capital and financial markets*

Implementation of the Polluter-Pays Principle is facilitated when capital and financial markets can adapt their products and services to support private sector investment. This in turn is linked to the establishment of sound macro-economic and structural policies that are needed to stimulate a positive investment climate. In addition, governments must establish the legal and regulatory framework that allows financial institutions to function efficiently; for example by regulating the banking sector, protecting creditors rights etc.

In response to the need for finance to support investments in the environmental and other sectors at the micro level in many developing countries, some 7000 microfinance institutions have developed, serving 16-30 million poor people world-wide. They are capitalised by both private and public sources. Community pressure can provide the incentive for loan repayment and support a virtuous circle of investment and growth. However, further efforts are needed to overcome the barriers to the further development of such institutions: namely, high risks, high transaction costs and problems in scaling-up as economic activity increases.

- Establish a policy and institutional framework to attract environmentally sustainable trade and investment flows

Developing countries that have opened their economies to trade and investment flows have generally grown faster and reduced poverty more successfully than those that have remained isolated. The growth that such policies generate provides resources that can be used for investment in environment and other priority sectors. However, the benefits of trade and investment do not accrue automatically and are not uniform across sectors and countries. Liberalisation by itself will not generate benefits unless it is accompanied by the establishment of an enabling framework for foreign and domestic investors. This includes establishing the rule of law, transparent administrative practices, effective anti-corruption measures, corporate governance requirements, and competition law. Effective provision for environmental protection, including environmental assessment procedures, are needed to ensure that trade and investment flows contribute to environmental sustainability. The New Partnership for Africa's Development (NEPAD) is one example of a regional initiative to develop an integrated framework to attract trade and investment flows in a coherent manner.

- Establish an effective system of local government, including local government finance

Public (rather than) environmental expenditures have been most important in the provision of infrastructure such as water supply and sanitation and solid waste management. These investments are usually made at the local level by municipally or privately operated utilities. Effective financing at the local level requires mandates and responsibilities to be matched by adequate access to finance. Local authorities need to be vested with the power to raise sufficient and predictable revenues, such as local taxes or user charges, and to have stable and transparent financial arrangements with higher levels of government. Sound regulations and effective institutions are needed to establish a suitable credit rating and to facilitate municipal borrowing.

Establishing local capacity is a major challenge in most developing and transition countries and is becoming more urgent given the trend to increasing urbanisation in these countries. Capacity building is particularly needed in financial management of municipal services, supervision of private operators of public municipal infrastructure and in introducing more results-oriented municipal budgets and multi-year plans of infrastructure investments with clear rules and criteria for prioritising capital projects.

- Build public and political support for environmental improvement

Implementation of the measures cited above will be strongly influenced by the political will shown by governments. Improving analysis of environmental issues, broadening access to environmental information, improving its dissemination and strengthening provision for public participation in environmental decision-making are all activities that can contribute to building the political and public support required. Carrying out these tasks is closely linked with the development of a strong, independent civil society. Governments also need to work with parliaments and ensure that adequate resources are allocated for priority environmental programmes.

### 3. Strengthening International Partnerships for Financing the Environmental Dimension of Sustainable Development

The WSSD will launch new partnerships to enhance the implementation of Agenda 21 and the Millennium Development Goals. These partnerships, which are described as ‘type two’ outcomes, will be formed between a wide range of stakeholders – governments of the North and South, business, civil society, the UN organs, the Development Finance Institutions – to deliver action oriented programmes within the priority areas agreed at Johannesburg. These programmes will be delivered at the international, regional and national level.

- Develop new partnerships around the Millennium Development Goals and integrate environment and development policies

Development co-operation is increasingly centred around the Millennium Development Goals and the new emphasis on poverty eradication. The new partnerships that are emerging between developed and developing countries place greater emphasis, *inter alia*, on developing country leadership and ownership; coherent, integrated policy approaches; stakeholder participation; and the development of effective systems of governance that foster market-based development.

Within this perspective, some participants observed that the environment probably is receiving less attention than it did at the time of the Rio Conference. However, the point really is that environment cannot be treated separately from other development concerns, and must be more clearly integrated with poverty reduction and sustainable development efforts. There are important poverty-environment linkages and these need to be analysed so as to provide a guide for policy development:

- In many developing countries, the poor often depend directly on natural resources and ecological services for their livelihoods
- They are often the most affected by unclean water and indoor air pollution
- The poor are particularly vulnerable to environmental hazards, such as floods and drought.

Addressing these poverty-environment linkages must be at the core of action to achieve the Millennium Development Goals; in particular eradicating extreme poverty and hunger, reducing child mortality, combating major diseases, and ensuring environmental sustainability.

#### The Millennium Development Goals

1. Eradicate extreme poverty and hunger
2. Achieve universal primary education
3. Promote gender equality and empower women
4. Reduce child mortality
5. Improve maternal health
6. Combat HIV/AIDS, tuberculosis, malaria and other diseases
7. Ensure environmental sustainability
8. Develop a global partnership for development

- Mainstream environment in national planning processes using tools such as national development strategies

National development strategies provide an important instrument for integrating environment with other development goals. Agenda 21, adopted at the Rio Conference, recommended that national strategies for sustainable development (NSSDs) should play this role. But the label is not important: the key issue is country ownership. For example, poverty reduction strategies should be sustainable if they adopt the principles set out in Agenda 21.

While NSSDs can be a useful approach, they are just one of a number of tools that can be used to mainstream environment into national planning processes. For example, In September 1999, the World Bank and IMF launched a process which involved developing countries preparing Poverty Reduction Strategy Papers (PRSPs). PRSPs “should be country-driven, be developed transparently and with broad participation of elected institutions, stakeholders including civil society, key development co-operation agencies and regional development banks, and have a clear link with the agreed international development goals.” Thus, PRSPs incorporate the key principles of sustainable development and provide an important opportunity to address linkages between poverty and environment and to integrate environmental concerns with social and economic policies. All IDA countries should prepare PRSPs by July 2002. The World Bank and the IMF are adapting their lending instruments and donors are adjusting their cooperation programmes to support the development and implementation of PRSPs.

However, a number of challenges need to be addressed in order to ensure the success of this approach. The World Bank recently conducted a review of how well PRSPs addressed environmental issues. Despite some good practice, poverty-environment linkages were often treated sketchily if at all. Weak areas included: how pricing and subsidies influence the environment; the institutional dimensions of environmental interventions; the absence of costing; and the relationship between policy inputs and environmental outcomes. Several international initiatives are underway to promote a better integration of environment into PRSPs: by OECD-DAC, and the Poverty-Environment Partnership (involving a variety of bilateral and multilateral donors). These initiatives are helping to identify more effective analytical tools and should be supported; but care must be taken to ensure that they are consistent and complementary.

- Mainstream global environmental issues into national development strategies and strengthen international mechanisms for financing global environmental problems, notably the GEF

Integrating global environmental issues into national development strategies has proven to be difficult. The main obstacles have been the perception, in many developed and developing countries, that the Rio Conventions are concerned with “environmental” rather than “development” issues, the trade-offs between short-term and long-term sustainable development requirements and the incremental costs required to address the global dimension of environmental problems above and beyond the costs of treating local problems.

Guidelines that OECD-DAC is currently finalising will provide practical support in addressing a number of these issues. They emphasise the need to demonstrate the linkages between global environmental issues, economic growth and poverty eradication; and to focus initially on win-win approaches. This can be done by addressing vulnerability and adaptation needs; developing integrated approaches for addressing the Rio Conventions; and creating markets for global public

goods such as biodiversity. However there may be difficult trade-offs to make, and this will require careful assessment of costs and benefits of various options, as well as their distribution across social groups. Impacts over time also should be examined from the perspective of environmental sustainability. Participatory mechanisms provide a means for identifying optimal solutions for trade-offs. Implementing such approaches will require a substantial strengthening of environmental capacities in the planning/economics ministries in developing countries and in development co-operation agencies.

The Global Environment Facility was established to finance the incremental costs of projects that address global environmental issues. The GEF should be substantially replenished, recognising that its mandate is being broadened to include a new focal area on land degradation and the new convention on Persistent Organic Pollutants. The GEF should continue to develop and assess innovative approaches for financing the incremental costs of global environmental projects, including examining how co-operation with other international financial instruments such as the prototype carbon fund might be strengthened. The GEF must simplify its administrative procedures to facilitate the more active participation of those developing countries with limited capacity. The effectiveness of other international financial mechanisms for addressing global environmental problems should also be enhanced.

- *WSSD should further consolidate international partnerships*

Achieving the Millennium Development Goals will require substantial financial resources as well as policy and institutional reforms. The World Bank estimates that an additional \$40-60 billion in aid would be required annually to achieve them by 2015. Despite the pledges to increase ODA made by some countries at Monterrey, overall levels of ODA will not be increased by these amounts. Apart from increasing the volume of ODA, developed countries could take the following actions:

- *Improving the quality of ODA.* This could include providing support for the development and implementation of country-owned development strategies that “mainstream” environment and that enable developing countries to attract more public and private financial flows. Further efforts should be made to untie aid. Further efforts are also required to enhance the co-ordination of ODA and its linkage to recipient country priorities. Finally, a clear distinction should be made between ODA and finance for global public goods (such as the atmosphere). Financing global public environmental goods should be in addition to development finance.
- *Improve market access for developing country products in developed countries.* The gain to developing countries from unrestricted access to OECD country markets for textiles and clothing, other manufactured goods, and agricultural products could total \$43 billion a year.
- *Further promote debt relief.* This could involve extending the current HIPC initiative to more poor countries. New generation debt for environment swaps provide another option. Such swaps may be negotiated bilaterally during debt restructuring discussions within the framework of the Paris Club. The deal that the Polish government negotiated amounting to about \$600 million provides a model.
- *Improve the environmental performance of export credit agencies.* Export credit agencies are an important source of development finance: they account for 16 per cent of poor countries’ long-term debt and new commitments in 2000 totalled \$2.4 billion,

or 80 per cent of gross capital market financing from private sources. Some of these projects can have important environmental impacts. Until recently, environmental assessment requirements of export credit agencies varied widely. Within OECD, most members of the Export Credit Group have now agreed on common approaches for environmental review mechanisms and further work is envisaged to achieve fuller consensus.

- *Promote environmentally-responsible foreign direct investment by home companies.* This could be done by encouraging multinational companies to comply with the OECD Guidelines for Multinational Enterprises. The Guidelines address various aspects of corporate behaviour, including environmental, and involve a network of government-established National Contact Points to review cases of non-compliance.

International Financial Institutions also have an important role to play in consolidating international partnerships. In the decade 1990-2000, World Bank lending for environmental projects amounted to \$8 billion; about half was in the water and sanitation sector. Another \$10 billion financed the environmental component of projects in other sectors. International Financial Institutions should continue to develop appropriate financial instruments and practices adapted to country-specific circumstances. The World Bank is also playing an important role in providing policy and technical guidance for achieving the Millennium Goals at least cost, based on best international practices. Regional development banks should consider strengthening their activities in this regard.

Throughout the Conference participants emphasized the importance of developing effective partnerships with civil society and the private sector. Some aspects of public-private partnerships are dealt with below.

#### **4. Improving the Use of Domestic Public Environmental Expenditure**

- *Establish clear linkages between the implementation of national development strategies and the national budgetary process*

Effective ways of linking development strategies, such as NSSDs, PRSPs and national development plans to the budget process include establishing a mid-term (3 years) framework for annual government budgets, and developing multi-year public investment programs that integrate capital and O&M budgeting. These arrangements provide an expenditure and governance framework within which sectoral plans can be assessed and prioritised. There is no one blueprint for putting such arrangements in place, but countries wishing to do so can draw on a great wealth of experience, mainly from developing and transition countries, that is reflected in guides produced by international organisations and development banks.

For certain sectors, e.g. water, solid waste and power, the development of long-term investment financing strategies can assist in setting realistic infrastructure development objectives. For example, financing strategies developed for the urban water sector in some New Independent States of the former Soviet Union (NIS) have highlighted the acute resource constraints facing some of these countries. The strategies have helped to focus the attention of the ministries concerned on policy reforms to attract private finance, the need for rigorous prioritisation of investments, and attention to efficiency improvements. Well-structured public investment programmes can provide a framework for comprehensive strategic allocation of public funds to

priority infrastructure investments and can help co-ordinate aid programmes. At the municipal level the investment and credit capacity of local governments in Central Europe has been enhanced by multiyear (4-6 years) investment plans.

- *Integrate environmental sustainability into public expenditure management*

Environmental policy makers should manage their expenditure programs so as to support macroeconomic and fiscal objectives; if not, they run the risk of further marginalising the environmental agenda. This calls for better integration of environmental expenditure programmes into public finance systems through efficient prioritisation, valuation of benefits, least-cost planning of environmental expenditure programs, improving methods for collecting environmental expenditure data, removal of perverse subsidies, and introducing environmentally related taxes and payments for environmental services. One promising instrument for promoting such integration is strategic environmental impact assessment, conducted by sector or central ministries, of their policies and regulatory and budgetary proposals. This approach has been pioneered in Denmark and other Nordic countries.

- *Develop, when needed, innovative institutions for managing public environmental expenditure programmes*

As a rule, public environmental expenditure programmes should be fully integrated into the comprehensive budget process. However, there may be circumstances when dedicated environmental finance institutions are needed to manage public environmental expenditures; for example, to manage resources generated by debt for environment swaps or from other external sources. In some countries earmarked environmental taxes and charges have been lodged in special purpose or comprehensive environmental funds. In many central and eastern European countries, in Central Asia and in China governments have established such funds to address “brown” issues, while a number of smaller “green” funds have been established in Latin America, Africa and Asia by a mixture of non-governmental, private and public actors. Some of these earmarked schemes in Central Europe have mobilised significant amounts of domestic finance for capital environmental investments in infrastructure and industry. A few of them are cost-effective, market friendly, fiscally sound and environmentally effective financing mechanisms and have also attracted significant external finance from donors and IFIs. Many others however, in particular in the NIS, remain insignificant, sometimes problematic players in the national environmental finance systems.

While earmarking is always a second-best solution, in some circumstances, for a limited time, and with built-in safeguards (such as periodic performance reviews and sunset clauses), it may help to compensate for imperfections in financial and capital markets, provide limited, targeted subsidies for firms that have liquidity or market access problems and help to increase the willingness to pay environmental taxes and charges.

If dedicated environmental funds are established, they should operate according to “best practice” guides that have been elaborated, for example by GEF and OECD. Some key elements include well defined environmental expenditure programs with clear, specific objectives; project selection criteria that emphasise high social/economic benefits including poverty eradication benefits; clear provisions for accountability, transparency, cost effectiveness and additionality; sunset clauses, innovative institutional arrangements and financial products that are dynamically tailored to the financing needs of particular

expenditure program and projects; operational autonomy from political interference, subject to accountability for performance and transparency; and decision making by rules rather than by discretion of individuals .

## **5. Conditions required for effectively harnessing private financial flows for the environmental dimension of sustainable development**

The increasing importance of private capital flows relative to ODA was a striking trend at the end of the 1990s. In addition, deregulation and the involvement of the private sector in areas that were previously largely in the public domain has intensified interest in how private capital investment could contribute to promoting sustainable development.

Despite the growing importance of private capital, most FDI flows to a limited number of countries: about 75% is intra-OECD, and two-thirds of FDI flows from OECD countries to developing countries goes to a relatively small group of countries in Asia and Latin America; very little reaches the poorest countries. Given the policy and institutional obstacles to private capital flows, it is clear that ODA will continue as a, if not the, major source of development finance in the poorest developing countries for some time to come. An important challenge is how ODA could help to leverage FDI flows without distorting markets or providing subsidies to the private sector.

Participants identified a number of actions that business, OECD and developing country governments could take in order to maximise the contribution of private finance to promoting environmentally sustainable development:

- *Implement environmental policies so as to provide a clear, consistent level playing field for the private sector*

There have been debates in the past about whether competition for FDI would lead to a “race to the bottom” in environmental standards; or whether FDI would accelerate the introduction of know-how and capital. The empirical evidence is mixed, and there is no simple answer. What is clear is that a robust environmental policy framework is the best insurance against unacceptable environmental impacts, and that large foreign investors are usually more interested in working with a stable, transparent regulatory framework rather than exploiting differences in environmental standards. Developed countries should support developing countries to establish effective environmental management systems, with the associated human and institutional capacities as part of the policy and institutional framework required to attract environmentally sustainable investment.

There have been fears that FDI merely leads to an accelerated depletion of developing countries’ natural capital. Financial institutions in particular have received much criticism for their lending to the developing country mining sector. Partly as a consequence of this criticism, many financial and development co-operation institutions are reluctant to engage in the mining sector, even though it is potentially important for the long-term development of resource-rich countries. Careful consideration needs to be given to a range of policies to ensure that the costs and benefits of mining operations are equitably distributed and contribute to sustainable development in the countries concerned.

- *Stimulate environmentally and socially responsible investment by adapting regulatory and institutional frameworks for market creation*

Socially responsible investment (SRI) in the US is estimated at more than USD 500 billion. However, at present most of this investment falls short of meeting sustainable development criteria. For instance, more than 80% of SRI funds in the US focus on "passive" screening criteria such as the absence of activities in tobacco or pornography in order to establish their portfolios. In Europe, the criteria used in SRI are more directly linked to sustainable development issues, but the movement has not reached a significant volume yet. Another problem is that much of this "green investment" focuses mostly on the largest multinational corporations whose shares are traded in OECD stock markets. In order to bring "green investment" more into line with sustainable development goals, it will need to go beyond its present scope and reach out to the markets of the developing world, as well as to small and medium sized enterprises, in particular those involved in providing environmental goods and services.

New "green" financial products are being developed by the traditional banks. New "green" venture capital funds are emerging. Some mutual funds have increased their "green" holdings in response to investor demand. These mechanisms and products, however, still represent only a small fraction of the mainstream financial industry. Several constraints to market-based financing remain, particularly in the field of biodiversity, suggesting that it represents a useful complement to, rather than replacement for, public support. Biodiversity investments tie up resources for a long time without the compensation of high financial return and low risk. Environmental products entail financial uncertainty and a risk profile that is relatively unknown to the financial sector and is difficult to estimate. Moreover, biodiversity businesses are often run by small and medium sized companies, which lack capacity, cash flow and collateral. Customers lack well-defined criteria to identify "green products".

Further market penetration can be facilitated by establishing rules and institutions under which markets for the commercially-viable provision of environmental goods and services can emerge. The most urgently-needed arrangements include certification and labelling of "green" products, independent certification, rating and ranking of green funds and provision of adequate, reliable information on green holdings of funds and on green products. Markets can be broadened by pilot development and dissemination of viable green business models or demonstration and dissemination of innovative risk management arrangements.

Market creation initiatives can be stimulated by governments. GEF, in co-operation with IFC, or various donors and international NGOs (e.g. IUCN, WWF) are blending public and private funds to develop viable demonstration initiatives. Some OECD countries (e.g. the Netherlands), provide tax subsidies for green investment on their territory. In the UK the government has just recently developed a regulation that requires pension funds to invest a share of their funds into companies that are identified as socially and environmentally responsible. Subsidies, however, should be used with a great care in order not to introduce distortions to market entry and inhibit long term sustainability of market based solutions. Many existing initiatives have actually emerged without government intervention.

Another example of a public-private partnership to promote socially and environmentally responsible investment is the UNEP Finance Initiative. Its main activities involve promoting educational, research and information-sharing programmes and projects; identifying best

practices; and identifying principles and tools for credit and asset management. Within this framework, the Banking and Insurance sectors are developing recommendations for submission to the Johannesburg Summit on further measures that they could take to integrate environmental considerations into their operations.

- *Governments and business should address the information constraints that currently limit green investment by promoting improved corporate reporting*

The lack of information on companies sustainability practices, and the lack of an agreed structure for presenting such information are important barriers to increased investment in “green projects”. Presently, data documenting the environmental and social practices of enterprises are difficult to compare and interpret, which considerably increases transaction costs for investors wanting to build-up socially and environmentally sound portfolios.

The development of an internationally recognised set of minimum standards for corporate reporting, such as in the UN Global Reporting Initiative, was identified as one useful step forward. Governments may also influence company reporting in various ways. One proposal was to require reporting of environmental liabilities in company accounts. A major challenge for initiatives of this sort is the diversity of criteria and methods currently used by investors for the appraisal of sustainability practices, as well as the huge diversity of industries.

## **6. Financing the urban water and sanitation sector**

Increasing the share of the world population with access to safe water is one of the Millennium Development Goals. Currently about 1.5 billion people have no direct access to drinking water, and four billion remain unconnected to sewerage systems. Solutions for water supply and sanitation need to be developed on a case by case basis, as these are likely to vary between the poorest and less poor developing countries. In some cases adjusting service levels to affordability may result in the usage of low-cost solutions such as water kiosks and stand pipes rather than more classical investments in infrastructure.

Notwithstanding these possibilities for cost reductions, the investment needs in the global water sector are huge. The World Water Vision presented at The Hague during the World Water Forum 2000, identifies an annual need for investment into capacity extension of \$180 billion over the next 25 years, not taking account of renovation or rehabilitation work. Building upon the conclusions from the International Freshwater Conference in Bonn, 2001, participants identified a number of steps that national and local governments could take to strengthen the financial basis for the water sector:

- *Integrate sanitation needs into strategies for achieving the Millennium Development Goal of improving access to safe water*

The Millennium Goal on access to safe drinking water aims at halving the proportion of people unable to access safe drinking water by 2015. However, the Millennium Goals do not include a goal on sanitation. More than 2.4 billion people do not have access to affordable and hygienic sanitation services. Johannesburg could facilitate consensus on a global target for sanitation in line with the Millennium Development Goal on access to water. It should also reach consensus on a global framework for action to achieve the MDG on water and a new target on sanitation.

Country-owned strategies need to be developed and supported within this global framework of action.

- Ensure the social and political sustainability of the water sector as a basis for its economic and financial sustainability

Water is an essential human need and a crucial input to much economic activity. Water supply and sanitation are services that are locally provided and consumed. Often the provision of water services has the characteristics of a natural monopoly. For these reasons, water is a particularly sensitive issue from the social and political points of view, where high levels of state intervention are required, and any changes directly affect significant portions of the population. These sensitivities can be particularly important when the possible involvement of the private sector is under consideration. Strong political and social support is required to ensure the success of the reform process, particularly in terms of the provision of social safety nets to protect the very poor and marginalised.

- Mobilise more revenue from water by gradually increasing tariffs to full cost recovery levels, accompanied by targeted measures to protect the poor sections of the population

In many developing countries and economies in transition cost recovery rates from water tariffs are very low. For instance cost recovery from irrigation water in Pakistan and the Philippines is less than 15%. A similar situation is found in the urban water supply and sanitation sector with average cost recovery rates of only 20% in Armenia and about 60% in the Russian Federation.

Subsidy reform and the objective of full cost recovery is essential for the financial viability of the water sector, whether utilities are publicly or privately operated. The obstacles to moving in this direction are described above as well as the need to ensure access to water services for poor and vulnerable groups. In Chile, reform of water tariffs and subsidies made it possible to reduce state aid to the sector from USD 107 million to USD 43 million per year.

- Improve the effectiveness of internal and external public funds through a shift from input to output based subsidies

Development aid for the water sector has traditionally tended to subsidise the cost of civil works, thereby providing little incentives to water utilities to increase their efficiency. Aid could be made more effective if it focused more on the actual performance of operations, either through linking subsidies to performance against a benchmark, or directly to the service levels provided to customers. For instance, subsidies could be provided for coverage expansion, e.g. a lump sum payment for each new customer connected.

- Attract more private sector finance by deploying more effective instruments for managing and allocating risk

While private sector participation in urban water infrastructure has generated high hopes for significant flows of additional finance and know-how, progress has been slow to materialise. During 1990-2000, private capital flows into the developing country water sector represented only about one tenth of those flowing into the telecommunications and energy sectors. . High levels of risk in many developing countries are one of the main factors. The private sector's assessment of country and project risks directly impacts on the direction of FDI flows; it also determines the rate of return, including a risk premium that private investors may require from their water operations.

Whereas risks directly linked to the water service, such as operational, customer and investment risks should clearly be allocated to the private operator of the service, other risks, such as currency exchange, political and macro-economic, may be allocated fully or partly to other stakeholders. Development agencies can help to mitigate these risks and thereby reduce the costs of private sector participation, for instance by providing support for high-cost, up-front investments, subsidies for the protection of the poor, or guarantees against currency exchange and political risks. They can also provide important support to governments in developing countries when they negotiate contracts with private sector operators and by helping to design regulatory frameworks adapted to the type of role played by the private sector in the provision of water services.