ORGANISATION FOR ECONOMIC
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Conference on

Financing the Environmental Dimension of Sustainable Development

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ISSUES PAPER

The first session of the Global Forum on Sustainable Development takes place 24-26th April 2002. The theme of the meeting is Financing the Environmental Dimension of Sustainable Development. The main issues to be addressed are:

- **Strengthening international partnerships for financing the environmental dimension of sustainable development;**
- **Best practice policies, tools and institutional arrangements for managing public environmental expenditure;**
- **Harnessing private financial flows for financing the environmental dimension of sustainable development.**

The discussions during the Financing for Development process and in the run-up to the World Summit on Sustainable Development have had a strong focus on resource mobilisation. This Conference will provide a complementary perspective by examining the effectiveness of using existing resources, both domestically and internationally.

This Issues Paper provides a brief introduction to some of the subjects that will be raised in the Conference and suggests some issues for discussion.

1. Policy Framework for Environmental Finance

1. The failure of markets to fully capture environmental costs effectively transfers those costs from the private to the public sphere. In the absence of appropriate government intervention, this results in a sub-optimal level of environmental investments. The policy response to environmental externalities in OECD countries is the Polluter-Pays Principle (PPP). The PPP requires the polluter to pay the costs of pollution control and prevention measures as defined in public policy. The government's role is to establish the policy and institutional framework from which the demand for finances emerges. On the supply side, the government traditionally has been responsible for the provision of public goods and, in exceptional circumstances, for limited and targeted financial assistance. Thus the PPP is essentially a principle for not subsidising private environmental measures. It is often complemented by the User Pays Principle that requires users of natural resources, like water, to pay for the costs associated with their use.

2. Creating effective demand for environmental investments requires the establishment of appropriate incentives for domestic firms and households. Environmental policies that *inter alia* specify obligations and sanctions for non-performance provide the main framework of incentives. To ensure the effectiveness of environmental incentives, the implementation and enforcement of environmental policy instruments must be credible and consistent. In addition, environmental policy makers can minimise the costs of complying with environmental requirements in a variety of ways; for example, by using flexible economic policy mixes that encourage cost minimization; by decreasing barriers to accessing technologies; by ensuring competition in the supply of technologies; by maintaining low tariffs and customs for imported technologies; and by lowering the cost and availability of information about technologies and financing options.

3. At the same time, it is increasingly clear that incentives for achieving environmental goals are no longer the exclusive business of Ministries of Environment. Microeconomic incentives facing firms and people are influenced by the environmental impacts of sector policies (e.g., energy, industry, transport and agriculture). Macroeconomic and trade policies, tax and subsidy schemes, may influence the relative prices of environmental goods and services; they may also have a bearing on the public resources that are available for environmental and other expenditure programmes. Social norms and pressures from civil society may encourage voluntary actions and standards of conduct by enterprises.

4. Implementation of the PPP requires effective capital and financial markets that can adapt their products and services to support private sector investment. Enabling legal and institutional frameworks to allow capital markets to function properly must be created and consistently maintained by governments. This involves *inter alia* effective supervision of the banking sector, protection of creditors' rights, hard budget constraints and avoidance of the "moral hazard" problem.

Public environmental expenditures are most important in the provision of environmentally related infrastructure, such as water supply and sanitation and solid waste management. These investments are normally made at the local level by municipally or privately operated utilities. Effective financing at the municipal level requires the local authority to be vested with the power to raise sufficient and predictable revenues, e.g. local taxes and user charges, and to have stable and transparent financial arrangements vis-à-vis higher levels of government. Sound regulations are needed to facilitate municipal borrowing (collateral requirements, borrowing ceilings, provisions for cost recovery). Public funds should be used very carefully to facilitate maximum leverage of private and external finance and to minimize crowding out of other sources of finance. Operators of municipal service companies need to be shielded from undue political interference. This also requires capacity in local governments to support investments financially, and to

prevent utility operators from abusing their monopoly power in certain infrastructure sectors where natural monopoly prevails (mainly water).

5. One of the major changes since the Rio Conference has been the changing roles of the public and private sectors. Increasingly the public sector is shifting from being the provider of environmental infrastructure to a facilitator and regulator of service provision. The private sector can be involved in provision of public environmental services in various ways; for example service or management contracts, leases or concessions, or full privatisation of assets. The urban water and sanitation sector will be a particular focus of attention in this Conference and this will enable these issues to be examined in more depth. It will also facilitate a discussion of the follow-up to the International Conference on Freshwater held in Bonn in December 2001.

Issues:

1. *What are the main drivers of demand for environmental finance in different regions and how they can be stimulated?*
2. *What are the main obstacles to implementing the Polluter-Pays and User-Pays Principles and how can they be overcome?*

2. International Partnerships

6. Developing countries face particularly difficult problems in addressing environmental issues. The World Bank has estimated that the economic costs of environmental degradation are between 4-8% of GDP in many developing countries; these costs are largely associated with impacts on human health and foregone economic opportunities arising from pollution and natural resource degradation. Developing the capacities to identify and manage complex environmental problems, and raising and managing the necessary financial resources both in the public and private sectors, represent major challenges. “Pollute now, clean up later” strategies are often the easiest option, even though they impose high costs. Securing support for addressing global environmental problems is more difficult than for local environmental issues.

7. Development cooperation is increasingly framed by internationally agreed development goals such as those contained in the Millennium Declaration. The goals focus on key aspects of human well-being and specify indicators to track progress toward their achievement. There are seven broadly agreed goals:

- Eradicate poverty and hunger
- Achieve universal primary education
- Promote gender equality and empower women
- Reduce child mortality
- Improve maternal health
- Combat HIV/AIDS, malaria and other diseases
- Ensure environmentally sustainability.

8. Environmental issues are associated with several of goals in addition to environmental sustainability; for example, poverty eradication and reducing child mortality. Ensuring access to potable water is a key element in the goal of environmental sustainability

9. While finance is not the only input required to achieve these goals, or not even the most important, it is clear that substantial financial support would be required to achieve the goals by 2015. Despite an increased interest in harnessing private financial flows, the World Bank has estimated that $40-60 billion a year in additional aid would be required; this would roughly double the existing levels of aid. This must be seen against the decline of aid during the 1990s.

10. These issues were addressed at the Financing for Development Conference in Monterrey in February 2002. Heads of State noted with concern the dramatic shortfalls in the resources required to achieve the goals in the Millennium Declaration. Important pledges were made, notably by the US and the European Union, that would reverse the decline in aid levels but which still fall short of the estimates mentioned above. Heads of State called for a new partnership between developed and developing countries. In addition, they agreed to: "commit ourselves to sound policies, good governance at all levels and the rule of law. We also commit ourselves to mobilizing domestic resources, attracting foreign flows, promoting international trade as an engine for development, increasing international financial and technical cooperation for development, sustainable debt financing and external debt relief, and enhancing the coherence and consistency of the international monetary, financial and trading systems."

11. The "new development paradigm" that has emerged from, inter alia, the Millennium and Monterrey summits, emphasises a long-term holistic vision of the development process; ownership of national strategies by developing countries; and the adoption of "programmatic", sector-wide rather than project-specific approaches. Poverty Reduction Strategy Papers (PRSPs) are key instruments for achieving development goals in the poorest countries. The World Bank and IMF are adapting their lending instruments and donors are adjusting their co-operation programmes to support the development and implementation of PRSPs. By developing sound macroeconomic and structural policies and institutional arrangements, PRSPs could provide confidence that any assistance provided to developing countries would be well used, and thereby create a basis for strengthened partnership.

12. The treatment of the environment in PRSPs was reviewed by the World Bank and IMF. The review indicates that although good practice was evident in some PRSPs, in many, poverty-environment linkages were treated sketchily if at all. Particularly weak areas included: how macroeconomic policies (e.g. 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. Some of these weaknesses are shared with other elements of PRSPs. The review recommends a set of "good practices" for countries and development partners (including the IFIs) to improve the usefulness and effectiveness of PRSPs.

13. One particular challenge is how to integrate global environmental issues into PRSPs. This will require an increased emphasis on the local aspects of global environmental challenges; building on "win-win" opportunities; reducing the vulnerability and adaptation needs of developing countries, particularly the poor who are most threatened by global environmental issues; stimulating markets for global public goods; and transferring financial resources to developing countries to cover the costs of generating global benefits that are "incremental" to those accruing at the national level.

14. The Global Environment Facility (GEF) was established in 1991 and restructured after the Rio Summit to finance four global issues: climate change; biodiversity; international waters and ozone depleting substances. Countries pledged $2 billion to the GEF in 1994 and $2.75 billion in 1998. The GEF

deploys a wide range of financial instruments in response to national demands. These range in size from $10,000 for small grants to NGOs to muti-million dollar support for country programmes with commensurate commitments. The third replenishment is currently under discussion and the outcome will have an important bearing on financing global environmental investments in developing countries in the years ahead. Expanding the scope of the GEF to cover the PICs and POPs conventions is also part of this discussion.

15. DAC estimates suggest that assistance for environmentally-related purposes accounts for about 15% of bilateral assistance flows; this was equivalent to about $8 billion in 2000. Water supply and sanitation services account for 40% of environmentally-related aid. However, these are not the only financial flows from the donor community to developing countries. In the decade 1990 to 2000 the World Bank lending for environmental projects amounted to nearly $8 billion with another $10 billion for environmental components of projects in other sectors. About half of the Bank's environmental lending portfolio is in the water and sanitation sector. In addition, the Bank provides a range of technical and advisory services and has as well-developed safeguards to manage potential environmental impacts of projects in non-environmental sectors. The Bank has recently reviewed its practices and developed an Environment Strategy that places a strong emphasis on development-environment links and on the environmental conditions that affect people's livelihood, health and vulnerability.

16. Export credits are another instrument of development finance, and their (potential) environmental impacts have received considerable attention of late. According to the World Bank, export credit agencies account for some 16 percent of the poor countries' long-term debt. New commitments to the poor countries from export credit agencies were $2.4 billion in 2000, or 80 percent of gross capital market financing from private sources. WRI has estimated that export credit agencies have financed nearly 50% of the private financial flows into energy-intensive sectors in developing countries and are involved in other projects with potentially important environmental impacts. Until recently there was no common approach to conducting environmental assessments of projects supported by export credit agencies. Within OECD, most members of the Export Credit Group have now agreed on common approaches for applying environmental review mechanisms and further work is envisaged to achieve fuller consensus.

17. Recent discussions about the various instruments of donor cooperation environmental assessment and export credits help to illustrate a more general point: there is a need to ensure their coherence from the perspective of promoting environmental sustainability.

Issues:

1. *Where are the greatest "win-win" opportunities for the new poverty-based development and environmental agendas? Where are the greatest needs for trade-offs?*
2. *What steps are needed to further mainstream environment in PRSPs and other partnership mechanisms? What further steps are needed to promote a more coherent approach to environmental sustainability among the range of instruments available to the donor community?*
3. *How can partnerships for addressing global environmental problems be strengthened in development cooperation programmes and in mechanisms such as the GEF?*

3. Policies, Tools and Institutions for Managing Public Environmental Expenditures

18. During the last decade developing countries and transition economies have recognised the importance of sound public finance and macroeconomic stabilisation as essential elements of the successful transition to an efficient economy and sustainable development. Environmental policy makers should manage their expenditure programs so as to support these objectives; if not, they run the risk of further marginalising the environmental agenda. This point is all the more important in the context of PRSPs which emphasise a holistic approach to using scarce public funds in support of priority social needs in a comprehensive budget framework. This calls for better integration of environmental expenditure programmes into sound public finance systems.

19. Environment must compete in public budgets with other pressing priorities like health and education. There is a scope for win-win actions. Tackling environmental problems can be a means of tackling poverty and vice versa. However, the win-win options are limited. Painful choices sometimes must be made between short term concerns of poverty and longer-term concerns of environmental sustainability.

20. In order for environment to compete effectively for public resources, it is helpful to calculate the benefits that accrue from environmental measures and to ensure that least cost methods are being used to achieve environmental policy goals. There is no absolute scientific criterion for determining whether any particular investment, policy or other budget proposal should or should not be accepted. There are also recognized difficulties in applying formal appraisal techniques because of lack of data, capacities and methodological problems. However, formal analysis, such as Cost-Effectiveness Analysis or Cost-Benefit Analysis can improve the quality of public polices by making the reasons for policy choices more transparent.

21. One particular challenge in policy appraisal is the treatment of long-term impacts and the specification of an appropriate discount rate. For normal applications, extending up to a few decades, there is something approaching a consensus on the method of derivation of the discount rate. The very long term, and the extremely long term, extending to centuries or millennia, present unusual problems for the technique of discounting. Ensuring sustainability requires convincing people to sacrifice some of their present consumption in order to prevent or mitigate damage to their welfare in an uncertain future. This challenge sharpens when we expect the present generation to make sacrifices, which would benefit future generations. Even worse from a sustainability perspective is that intergenerational impacts have a strong distributional equity dimension. Proposals for preventing or mitigating major global environmental problems would often require rich countries to bear most of the costs now in order to provide most of the benefits to poor countries in the distant and uncertain future; an unfortunate combination!

22. On the basis of international experience there is a consensus that one requirement for efficient and effective budgeting for sustainable development is a medium term budgetary framework, extending over about three years. There is no blueprint for achieving this that would apply to all countries. There is however a great wealth of experience, mainly from developing and transition countries, which is now well recorded in guides produced by the international organisations (OECD, World Bank, ADB).

23. 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 some NIS water sectors have highlighted the acute resource constraints facing some of these countries, helping to focus attention on policy reforms to attract private finance, the

need for rigorous prioritisation of investments, and attention to efficiency improvements. For capital budgeting the fundamental lesson from experience is the need to integrate capital and public current expenditure planning. Public investment programmes (PIPs) 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 capacity of local governments in Central Europe has been enhanced by multiyear (3-6 years) investment programs (also known as capital improvement plans).

24. Strategic environmental impact assessment (SEA) of the budget developed in Denmark and some other North European countries provides a different approach for integrating finance and environmental policies by formally introducing environmental assessment into appraisal of government spending plans. The methodology of the SEA of the Budget is still evolving and the experience with this instrument is too short to allow ex-post evaluation of results. Nonetheless, it is reported to have improved the quality of political bargaining within the government.

25. In some countries, separate environmental financing institutions have been established:

- Almost all the countries of Central Europe and Baltic (CEB), the New Independent States (NIS) and China have set up comprehensive environmental funds (from one to several thousand). These funds are established and controlled by environmental authorities and are capitalized by earmarked charges and taxes. The aggregated annual disposable resources of these funds ranges between 1.5 – 2 Billion USD, with the bulk of these resources concentrated in Central Europe (30%-40% in Poland). Performance reviews (e.g. conducted by OECD and the World Bank) identified common problems with unfocused expenditure programs, inadequate efficiency, transparency, over-politicisation, and excessive dispersion of resources. However, the few successful funds in Central Europe have demonstrated that government controlled funds can be made cost-effective, market friendly, fiscally sound and environmentally effective financing mechanisms. These funds have attracted sizeable foreign funding.

- In Africa, Asia and Latin America a number of “green” funds (not to be confused with green investment funds found in developed countries) have been established. They typically use a variety of revenue sources including: government budgetary allocations, public and private donations, earmarked user fees and taxes, debt-for-nature swaps and environmental service payments to provide small grants to finance biodiversity conservation and forestry. Because of the concerns about the legitimacy of government-controlled institutions these funds are typically established as trust funds, associations or foundations supervised and managed by independent boards consisting of private financiers, NGOs, foreign and domestic government representatives. A few governments have also established "brown" funds that finance pollution abatement. The relative youth of the environmental funds in developing countries has meant that ex-post evaluation (e.g. conducted by the GEF) has focused mainly on institutional aspects of fund development rather than on their impact on environment. Although assessment was generally positive, the problems identified prompted the GEF to outline the factors that are important for establishing and operating a Trust Fund.

- Since 1987, over $1 billion in funding has been generated through debt for nature and debt for environment transactions. In early years, most of the swaps were trilateral transactions involving private debt and international NGOs as deal brokers and intermediaries. Since the beginning of 1990-ties bilateral swaps of official debt have been negotiated. Bilateral swaps involve government-to-government deals that follow a special enabling provision in the agreement between the debtor and the Paris Club. This form of transaction has the potential of generating large revenues with lower transaction costs. For example almost a half of the total value of swaps worldwide is accounted for by the bilateral debt for environment swap transactions with Poland (Polish EcoFund). Resources made available domestically through swaps are either earmarked for a specific portfolio of projects (typically

implemented with limited competition by firms from a creditor country) or allocated to a dedicated organisation (a Fund), which, under international supervision, finances projects on competitive basis. This latter form has proved to be more effective and efficient way of disbursing DFE resources. Several NIS are looking at opportunities of debt for environment swaps just now.

26. Experience worldwide clearly shows that no single institutional arrangement or single financing instrument can fit all of the environmental financing needs in any country. However, successful environmental expenditure programs share a few distinct characteristics. They have carefully chosen, specific objectives that can be convincingly demonstrated as a social priority. They have innovative institutional arrangements and financial products that are tailored to the specific financing needs of the given program. In contrast, weak environmental expenditure programs often focus on particular organizational forms or financing instruments before defining specific expenditure objectives and programmes. Drawing from practical experience in several transition economies, the OECD has developed a set of "good practices" to guide the design and management of public environmental financing institutions in ways that are consistent with the basic principles of public finance. They stress fiscal discipline, the efficient allocation of resources, operational efficiency, accountability, transparency and comprehensiveness of the budget framework.

Issues:

1. *What tools and policies are most useful for integrating environment into public expenditure programs at national and local level?*
2. *Under what circumstances might dedicated domestic environmental financing mechanisms be useful? Are they consistent with the" new development paradigm"?*
3. *Is there a future for debt for environment and debt for nature swaps? What are the best institutional arrangements for these transactions?*

4. Harnessing Private Finance for environmental goods and services

27. The increasing importance of private capital flows relative to ODA was a striking trend at the end of the 1990s. The sharp fall in FDI flows in 2001, and the reversal in the decline of ODA that emerged from the Monterrey Financing for Development conference in February 2002, will probably not affect this underlying long-term trend. At the same time, 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, including its environmental dimension.

28. 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 flows to 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.

29. There have been debates about whether competition for FDI would lead to a "race to the bottom" in environmental standards; or whether FDI would facilitate the introduction of know-how and capital. The empirical evidence is mixed, and there is no simple "aggregate" 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. This and other factors (such as access to markets and raw materials, and labour costs) are usually more influential in determining location decisions.

30. Urban water and sanitation - which is closely linked to the development goal of improving access to safe water - is one sector in which there has been much interest and experimentation to involve the private sector. However, progress has been slower than originally expected. There are many projects involving private sector participation, but private capital flows are only one-tenth of those invested in the ICT and energy sectors, and the number of private projects has levelled off since the mid 1990s. Various factors account for these trends: the relatively lower returns on investment; high capital intensity and long pay-back periods; political and currency risks; unclear regulatory frameworks; political opposition and concerns about how poor and vulnerable groups would be guaranteed access to water services; and tariffs that are too low to support investment. Establishing appropriate policy and institutional frameworks and allocating and managing the risks involved in such projects are key obstacles that would need to be overcome to boost private sector participation in this sector.

31. In many countries, governments and the private sector are moving beyond traditional investment facilitation. Many large companies have rejected a reactive approach to environmental regulation and have integrated environment and sustainable development into their corporate strategies as a source of long-term comparative advantage. In some countries, negotiations between the government and companies have resulted in initiatives that go beyond regulatory requirements. For some companies, this can provide powerful incentives for pursuing corporate goals while staying one step ahead of the "regulatory game". However not all companies have the same goals. Effective monitoring and verification procedures are needed to ensure the credibility of such schemes and to identify "free riders". Retaining the option of government intervention is also usually a prerequisite for success.

32. A recent OECD study using data bases covering over two thousand organisations in thirty countries shows the substantial progress that has been achieved in integrating social and environmental objectives into corporate operations. Many have signed up to codes of conduct and environmental charters. In the OECD Guidelines for Multinational Enterprises were elaborated with participation by business, labour and NGO representatives. OECD members made recommendations concerning business conduct in areas such as labour relations, environment and anti-bribery, and established National Contact Points to deal with possible complaints for non-compliance. In addition, many major companies publish environmental reports, or sustainability reports that review performance in relation to the "triple bottom line": finance, social and environment. However, no common standards for environmental reporting have yet been agreed.

33. These initiatives by the private sector respond to market pressures (the "business case" for corporate responsibility), the need to manage legal and regulatory compliance and to "softer" pressures not written down in law books. Thus, although these initiatives are essentially private, they are influenced in various ways by the broader environment -- economic, cultural, social, legal and political -- from which they emerge. The implication of this is that, if the broader environment is not functioning well, the business sector will not have the incentives to undertake such initiatives.

34. Greater access to information has enabled consumers who wish to do so to make choices taking account of environmental performance. There are clear "reputational risks" for companies that exhibit poor environmental performance that may result in consumer boycott of products or difficulties in retaining staff. Consumers' environmental preferences have also stimulated a response from the financial sector. A

variety of "green funds" have been developed. They represent only a small proportion of the total industry, but some have shown positive returns over a decade and demand is rising. UNEP has developed an initiative with the financial sector that examines, amongst other things, the identification and quantification of environmental risks and the development of financial products and services that could promote environmental protection.

35. Biodiversity illustrates some of the opportunities and constraints of engaging the financial sector for environmental purposes. Biodiversity has a strong public goods character that inhibits the development of markets for its products services. Nevertheless the banking sector, venture capitalists and open funds have developed an array of financial products that facilitated market creation. Investor demand for green funds with biodiversity holdings have grown steadily over the last ten years and venture capital funds have also begun to be involved. Yet, biodiversity products and services still represent only a fraction of the business of the mainstream financial industry and of larger timber or tourism industries. This trend is likely to grow but is nonetheless limited. Some of the main constraints to the further development of the market include: the lack of certification procedure for biodiversity products; the long-term nature of investments, which makes them relatively "illiquid"; and lack of information, including information about the firms active in the sector.

Issues:

1. *How can the public (including donors) and private sectors cooperate more effectively in areas like water supply and sanitation to promote more private sector participation within an agreed regulatory framework?*
2. *Where are the opportunities greatest for market creation and a greater involvement of the private sector in providing environmental goods and services?*
3. *What are the opportunities and constraints for further engaging the financial sector in promoting environmental sustainability?*