Good Practices of Public Environmental Expenditure Management in Transition Economies

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The views expressed in this paper are those of the author and do not necessarily reflect those of OECD or its Member countries. The work on this paper is still in progress and the author would welcome your comments to grzegorz.peszko@oecd.org.
Lessons learned from transition countries’ experience with organizations managing public sector expenditure for environmental purposes

1. In most countries undergoing transition to market economy, environmental expenditures by public sector, measured by different relative yardsticks, are lower than in mature market economies. A number of explanations of this fact have been identified in the literature. These arguments usually draw on the public goods characteristics and externalities involved in provision of environmental goods and services. These arguments are reviewed in a background paper to session III.2.

2. This paper originates from yet another assumption that in addition to other reasons public institutions managing environmental expenditure in transition economies attract few resources because they do not always operate according to acknowledged standards of sound public finance. Environmentalists’ constituencies (government, NGOs, environmental service businesses) often represent excessively parochial, “demanding” position which may be disfunctional with respect to the overall government and society effort to achieve macroeconomic stabilisation.

3. The goals of macroeconomic stabilisation and solid fiscal position of the public sector are not part of the mandate of environmental policy. On the other hand, environmental (and indeed any other sector) policy, which obstructs the goals of the rest of government is bound to be marginalised. As experience of some countries show, it is possible to design environmental policy institutions in such a way that they would contribute to the solution, and not to obstruction, of the goals of the wider challenges facing transition economies. This paper draws from the practical positive and negative experience from several transition economies and attempts to synthesize this experience as a set of “good practices”. They are tailored at integration of public organizations managing expenditure for environmental purposes into a sound public finance system. These good practices also build upon the OECD, World Bank and Asian Development Bank work on good practices in general public expenditure management. The focus of this paper is on the expenditure side of public finance, and not on the revenue side.

4. The traditional focus of the discussions on institutional set up for environmental expenditure management in transition economies has been and often still is on government controlled earmarked tax funds due to their distinctive role played in a few countries of Central and Eastern Europe (CEE). However, the empirical analysis of government controlled environmental funds in CEE, NIS and China conducted by the OECD Secretariat of the Task Force for implementation of Environmental Action Programme for Central and Eastern Europe, indicates that the focus on funds in the transition economies has often been disproportionate to the role they actually played in environmental financing (see background paper for session III.2). Only a few funds in Central Europe can be called success stories. The majority of the CEE funds and virtually all the NIS and Chinese environmental funds remain insignificant, and sometimes problematic, players in financing environmental expenditure. They have often provided important financial support to environmental administration affected by frequent budget cuts, but their role
in financing environmental investments is negligible. In fact one may argue that this disproportionate attention paid to environmental funds by policy makers may have prevented the development of more effective institutional arrangements for managing public environmental expenditure. Several funds are actually disappearing or facing very uncertain future under the constant pressure by government authorities and international organizations dealing with fiscal policies. It is clear that earmarking by itself, has not protected the decline of public environmental expenditure. Indeed, earmarking may have contributed to the further marginalisation of environmental expenditure within public budgets.

5. Despite acknowledged problems, the few “success stories” in Central Europe have demonstrated that even government controlled environmental funds can be made economically efficient, fiscally sound and environmentally effective financing mechanisms in countries coping with environmental problems of transition. If properly designed and managed they can also be part of the process of building efficient market institutions.

6. The few funds in CEE countries that had made the greatest progress in implementing the St. Petersburg Guidelines have become internationally recognised and were often able to attract significant external resources (e.g. EcoFund - Polish debt-for-environment swap fund). However, these funds operate in the most successfully reformed countries, where transition to market economy, which was considered as the main rationale for earmarked, extra-budgetary environmental funds, is coming to an end. These funds find themselves under growing pressures to consider post-transition scenarios. The scenarios include a range of options, from “privatisation” and transformation into commercial banks, to integration back into the budget and administration.

7. The first international effort to define a set of minimum performance standards for environmental funds resulted in the “St. Petersburg Guidelines on Environmental Funds in a Transition to a Market Economy” (See Box 1). These Guidelines were discussed and agreed upon at a Conference held in St. Petersburg in 1995 under the auspices of OECD Secretariat of the Task Force for implementation of Environmental Action Programme for CEE (EAP Task Force). This meeting gathered environmental and finance experts and officials from Environment and Finance Ministries and Funds officials from the CEE and NIS countries as well as representatives of the European Commission, IFIs and the donor countries. Not only have these Guidelines helped with the design of new environmental funds in the region, but they have also served as an effective tool for reviewing the operations of existing funds as well as designing technical assistance programmes.

Box 1. Key recommendations of the St. Petersburg Guidelines on Environmental Funds in a Transition to a Market Economy

- In order to avoid or minimize the long-term economic inefficiencies inherent in earmarking of funds, expenditure should be targeted to meet environmental priorities and promote projects with large environmental benefits relative to their costs.

1 Using the framework of the St. Petersburg Guidelines OECD and EC Phare experts have conducted performance reviews of the Polish Ecofund (OECD/Phare, 1998), the Estonian Environmental Fund, the Czech State Environmental Protection Fund and the Slovenian Environmental Development Fund. In addition environmental funds in Kazakhstan and Moldova were reviewed in 2001 and 2002. These reviews were conducted within the framework of the Task Force for the Implementation of Environmental Action Programme for Central and Eastern Europe.
Environmental funds should play a catalytic role in financing, ideally offering no more support for projects than is necessary and adapt to changing economic conditions.

Environmental funds should be used in conjunction with, and reinforce, other environmental policy instruments, such as administrative direct regulations or economic instruments.

Environmental funds should develop an overall financing strategy, follow clear and explicit operating procedures for evaluating and selecting projects, adopt effective monitoring and evaluation practices, and make effective use of internal and external expertise to enhance administrative efficiency.

For investment projects, funds should have well-designed programme and project cycles to ensure cost-effective use of resources.

Environmental funds must not compete with emerging financial markets but should leverage financing from private sector enterprises and financial institutions 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.

Source: OECD, 1995a.

8. Five years after the endorsement of the St. Petersburg Guidelines, the situation in transition countries has evolved considerably. During this period, they have all struggled to achieve macroeconomic stabilisation and fiscal consolidation, though with different degrees of success. All countries, however, have painfully recognised the importance of establishing healthy and sound system of public finance, as an essential element in the successful transition to a market economy. Environmental funds are typically small players in the national environmental finance systems, which are typically small elements of the public finance systems. Therefore, at the end of the first decade of transition it is unnecessarily restrictive to limit the debate to environmental funds only. The fundamental challenge is to look beyond funds and to integrate all environmental finance institutions and mechanisms with the system of public finance. Environmental finance mechanisms will not be effective if they undermine the fundamental goals and principles of public finance; indeed in such cases they will eventually be abolished. Examples of various institutional arrangements for managing public environmental expenditure are presented in Box 1.

**Box 2. Institutional arrangements for public expenditure management**

- **Department of the government** (at different level) responsible for direct purchase of goods and services
- **Project implementation unit** established within a government department in order to implement specific government expenditure programme included in the budget.
- **Autonomous/decentralized government agency** financed from the budget and created in order to separate the delivery of services or administrative tasks from policy formulation.
- **Special purpose fiscal unit** granted independent but restricted taxing powers (e.g. river basin water agency or forest agency may be organized along these lines).
- **Public utility** with authority to collect user charges and responsibility to develop, maintain and operate collective infrastructure (e.g. municipal water, solid waste or district heating company).
- **Budgetary fund with its own management structure and autonomous earmarked revenue source within the budget.** Such funds may be established within the government at the sector or region level, and sometimes are co-financed by transfers from the general budget. Some environmental protection funds in CEE and NIS countries belong to this category. Other examples include road funds, disability trust funds or social security funds.

- **Budgetary fund managed outside of the government,** with its own autonomous earmarked revenue source. Such funds may have independent legal status, although their revenue and expenditure plans are approved annually in the budget law. Managerial autonomy vis-à-vis government vary from country to country, ranging from specialized teams within the government department to autonomous institutions. Several environmental protection funds in CEE and NIS countries are in this category.

- **Extra-budgetary fund, managed outside the government,** with its own, autonomous earmarked revenue source. Such funds always have an independent legal status and assets. Their revenue and expenditure programmes do not require annual approvals in the budget laws, although their budgets may be added to the general budget as an annex. Their control by the government, and managerial autonomy vis-à-vis the government may also vary from country to country. Most autonomous environmental funds in CEE countries (e.g. Polish funds) belong to this category.

- **Special-purpose government controlled fund** (revolving or not) owned by the government, but established outside of government departments and capitalized by discrete budgetary transfers (e.g. formerly Slovenian Environmental Development Fund).

- **Independent intermediary for the government (grant or debt) expenditure programme.** The intermediary bears a contractual obligation to disburse government resources on terms and conditions specified in the agreement with the government. Such expenditure programmes are usually funded by discrete budgetary transfers, but can also be contracted by special purpose fiscal units, autonomous agencies or autonomous funds. Many institutions may act as intermediary. A government-owned entity (e.g. bank, fund or agency) may be contracted to disburse grants or soft loans. A private sector entity (e.g. bank, leasing company or investment fund) may also be contracted to provide specific services related to implementation of government expenditure programmes. The range of services provided by the private sector may be very wide, extending from selected elements of project appraisal through full financial intermediation for loan financing (with or without co-financing) to concession for project implementation and operation. The contract may also provide for the interest subsidies paid by the government to cover part of the cost of the loans extended by a commercial bank to targeted beneficiaries and/or for specific types of projects.

- **Government-owned public fund established to manage expenditure programmes co-financed from external loans or grants.** Such funds receive usually matching financing from the general budget or from specific domestic revenue sources. A significant degree of managerial autonomy and insulation from politics is usually required by external financiers. Polish and Bulgarian debt-for environment swap funds belong to this category.

- **Counterpart funds** generated by sales of commodity aid need to be managed under specific procedures, taking into account the requirements of the donors.

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9. The future of government controlled special environmental funds is best considered in the wider context of environmental and public finance. Subsidies always distort markets and increase public sector deficit. Therefore, the need for environmental subsidised finance is to be carefully reconsidered in the light of the generic Polluter Pays Principle (the "no-subsidy" principle) that guides environmental policies in developed OECD countries. Better understanding of the scale and the nature of that need may help to target subsidies better so that the funds can bring a genuine value added where and when it is really necessary without obstructing the process of transition to a market economy.
10. It is not policy relevant to advocate either proliferation, or elimination of environmental funds as a matter of principle. Rather we call for the critical, case-by-case revision of their value added and for more precise definition of their "niche" vis-à-vis other environmental financing institutions. Where the value added can be convincingly identified it recommends their reform and strengthening in line with internationally recognized performance standards and in the context of the broader system of public finance.

11. Fiscal discipline, efficient allocation of public funds, operational efficiency, accountability, transparency and comprehensiveness of the budget are internationally recognized essential elements of healthy public expenditure management and arguably the conditions for development to be sustainable. Box 2 below summarizes the main principles of sound public finance.

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<th>Box 3. Principles of sound public finance</th>
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<td>The three main goals of sound public expenditure management systems:</td>
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<td>- <strong>Fiscal discipline</strong> means control of total government expenditure including central and local government budgets, state-owned enterprises and extra-budgetary funds. Absence of constraints is likely to result in large, unsustainable deficits and unstable macroeconomic environment. Fiscal discipline requires ceilings imposed on total public sector expenditure and on sectoral financial envelopes. Special care is required to control multiyear explicit legal commitments, such as debt servicing as well as implicit or contingent liabilities (e.g. guarantees).</td>
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<td>- <strong>Allocative efficiency</strong> means the best outcome of prioritizing competing claims of different social objectives on scarce public funds (within aggregate fiscal discipline). Difficult choices must be made between the social benefits of various objectives in education, health service or environment. Ultimately the outcome is achieved through political bargaining, ideally supported by adequate information provided to all parties about trade-offs that are being made. Impersonal rules for evaluating the relative importance of choices improve the quality of prioritization. Central Ministers are in comparatively better position to ensure efficient allocation of public resources among different sectors. The line ministers have a comparative advantage (e.g. information) in programming and allocating resources within their respective responsibility areas, subject to the external constraint on the sectoral envelope size.</td>
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<td>- <strong>Cost effectiveness</strong> implies achieving objectives at minimum costs. Cost-effectiveness test is best applied when benefits are difficult to measure and value or when the objectives have already been chosen. Contrary to allocative efficiency, cost-effectiveness is primarily a technical concept and always suffers from political influences. It requires managerial autonomy over appraisal of specific projects and responsibility to implement defined expenditure programs subject to clearly defined accountability for performance. Requires competent individuals in civil service attracted through adequate, performance-based compensation and a merit-based recruitment and promotion system.</td>
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<td>The necessary conditions for achieving these goals</td>
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<td>- <strong>Transparency</strong> entails low-cost access to relevant information. Public sector institutions should use acknowledged international standards of accounting and disclosure of fiscal and financial information to controlling bodies and to public. Requires independent assurance of integrity of financial reports through external audits and a mechanism to ensure that external audit findings are reported to the controlling bodies and that remedial action is taken.</td>
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Accountability means the capacity to hold public officials liable for their actions and performance. Accountability measures must always address three questions: accountability by whom; accountability for what, and accountability to whom. It is advisable to define performance in terms of objective, impersonal measures. Effective accountability has two components: responsibility and consequences.

Comprehensiveness of the budget. Ideally all public sector revenue should be pooled together in the general fund and the legislature, guided by the executive body, should freely allocate these common resources to different public expenditure programmes, so as to equalise the marginal social benefit of the last coin spent for each programme. Some economists, however, advocate earmarking and separate bargaining over some tax-expenditure programme.

Source: Allen, Tommasi (2001), Schiavo-Campo, Tommasi (1999); World Bank (1998)

Good Practices of Managing Public Environmental Expenditure

12. The good practices of public environmental expenditure management can be used as a framework which transition countries could use to review -- and if necessary reform -- their environmental financing institutions, including government controlled environmental funds. The reform towards better integration into sound public finance can be measured by applying checklists of good practices to mechanisms managing public environmental expenditure. These good practices build upon St. Petersburg Guidelines and upon 10 years of practical experience of reviews of environmental funds in transition economies. They are applicable but not limited to earmarked environmental funds.

13. These good practices are applicable but not limited to earmarked tax environmental funds. Indeed many other institutional arrangements are possible to manage public environmental expenditures. The performance of existing and newly established environmental expenditure institutional schemes, in particular extra-budgetary environmental funds and autonomous environmental funds, can be assessed against these good practices of public expenditure management. These good practices are necessary, but not sufficient conditions to ensure that such institutions operate in accordance with the criteria of sound public finance.

14. The Good Practices are considered in three dimensions:

- environmental policy,
- public finance,
- effective fund (money) management

15. Performance in each dimension can be audited by applying corresponding checklists presented below. Passing each of these three tests however should be considered as a prerequisite in all earmarking arrangements, autonomous funds, special public agencies or expenditure
procedures. Without them, such arrangements are very likely to turn into financial and environmental failures. Misuse of public money may also occur.

**Figure 1: Performance triangle of environmental funds**

16. Pathways for the implementation of the Good Practices will be different in different countries, reflecting different levels of economic and institutional development as well as maturity of markets and public finance systems. A common "pathfinder" is presented as a guide both for countries considering the reform of existing environmental financing institutions and for those that are considering establishment of new ones. It can also serve as the shortest manual how to use the toolkit for improving environmental expenditure management by public financing institutions in transition economies.

**Box 4. “Pathfinder” for implementation of Good Practices of Public Environmental Expenditure Management**

1. Identify SMART environmental objectives (*e.g.* using environmental financing)
2. Determine if government subsidies are necessary to achieve these objectives

3. Select the best organizational arrangement for managing the public subsidies

4. Implement and enforce good practices of public environmental expenditure management by organizations managing public environmental expenditure. Apply three checklists listed below:
   - Checklist for performance as environmental policy instrument
   - Checklist for performance as instruments of public finance
   - Checklist for performance as a manager of money

Checklist 1. Performance as environmental policy instrument

1. Public financial aid to environment is only launched when there is solid analysis demonstrating that they are necessary for achieving environmental policy goals. If these goals can be achieved with administrative or economic instruments, or with private expenditure, then public financial resources are saved for other uses.

2. Organizations managing public environmental expenditure have clear spending programmes. These programmes have specific, measurable, agreed, realistic, time bounded objectives and a set of written rules guiding investment decisions that enable the objectives to be met. Their objectives are an integral part of wider environmental policy goals established through a political process led by the Ministry of Environment.

3. Project selection criteria ensure that limited funds “buy” the greatest environmental benefits possible. To this end projects are selected through competitive procedures using objective selection criteria. Cost-effectiveness (minimising costs of achieving any effect) is the main appraisal and selection criterion. Cost-effectiveness is a legal requirement and a key indicator for assessing performance of individuals and institutions. The criteria and procedures are specified in the legal documents and/or operational documents. They are legally binding and accessible to the public.

4. Organisations, their procedures and project selection criteria are relatively stable and consistent over time. At the same time, objectives, modalities and project selection criteria are periodically reviewed.

5. Organisations managing environmental expenditures through extra-budgetary or special management schemes generally do not subsidize operational costs of environmental infrastructure installations or running costs of environmental administration. Support is normally limited to financing investment in fixed assets or precisely defined individual non-investment projects which are not the regular duties of administration (for which standard budgetary financing should be used). In exceptional instances where their operations or existence is threatened by cash-flow problems assistance is given for strictly limited time period.
Organisations managing environmental expenditures are not excessively driven by equity considerations if it undermines their environmental effectiveness. To the extend practicable, equity issues are separately addressed by targeted instruments of social policy.

**Checklist 2. Performance as instruments of public finance**

1. The number of extra-budgetary environmental funds or agencies as well as budgetary earmarked funds is kept to a necessary minimum in order to facilitate fiscal control by the financial authorities and to avoid excessive fragmentation of resources.

2. Sunset clauses or periodic reviews of earmarking are mandatory and are specified in legal acts in order to prevent perpetuation of the funds longer than needed on efficiency grounds.

3. Distinct lines of responsibility are clearly assigned to all supervising, managing and executive bodies. Overlapping responsibilities are avoided. All individuals are held accountable for decisions within their areas of responsibility. Accountability systems is based on acknowledged international standards. Institutions managing public environmental expenditure strive to implement these systems even if they are not fully applied in other sectors of public finance. Arrangements involving conflict of interests are eliminated.

4. Responsibilities policy making and priority setting are institutionally separated from those for administration of funds and project appraisal.

5. Strict financial prudence and transparency, supported by both cash and an accrual accounting system based on the provisions for international standards, is introduced and approved by the finance authorities.

6. Regular ex-post reporting, according to a transparent expenditure classification system, is regularly conducted and publicly disclosed. Mandatory internal as well as independent external financial, legal and performance audits are regularly carried out.

7. An estimate of the revenue and the corresponding expenditures of all extra-budgetary funds is provided in the budget, at least as an annex. Extra-budgetary institutions managing environmental expenditure are not allowed to incur a deficit without the explicit, prior approval issued by fiscal authorities.

8. Direct procurement of goods and services is institutionally separated from appraisal and selection of projects for public financial support. Budgetary institutions that are responsible for procurement choose suppliers or contractors, but other institutions (e.g. different department in the Ministry) decide which projects should be funded and when. Assigning responsibility for these functions to the same institution involves conflict of interest.

9. Extra-budgetary environmental institutions are not legally allowed to assume contingent and implicit liabilities without prior permission of the fiscal authorities. Medium-term financial forecasts, including contingent and implicit liabilities are regularly prepared by all public financing institutions and disclosed in financial statements. Statements on debt and contingent liabilities of extra-budgetary environmental institutions are presented along with the budget of the Ministry of Environment to the Ministry of Finance.

10. If money managed by the environmental agency come directly or indirectly from compulsory transfer payments (taxes, charges, fees) they are treated as public funds in the meaning of the laws of public finance, public procurement and state aid and are subject to the usual fiscal discipline in the entire public finance sector. They are guarded against corruption and fraud. If there are justified reasons to relax typical, rigid budgetary discipline, additional special
provisions ensuring competition, transparency, accountability and cost-effectiveness are implemented.

11. Public environmental subsidies do not distort competition in financial markets nor obstruct the development of private financial institutions. Financial products used by public institutions do not compete with financial products offered by commercial banks or investment funds to the same customers and to the same project category. Leveraging private finance is an important performance criterion.

12. Internal earmarking (e.g. sub-funds within funds) is avoided as it infringes on efficiency. If internal earmarking is unavoidable safeguards are in place to prevent inefficient resource allocation and perverse incentives.

Checklist 3. Performance as managers of money

1. Management bodies and persons have sufficient degree of managerial autonomy to implement given expenditure program. The political interference in the selection of specific projects and beneficiaries is strictly limited and ruled by rigid procedures. Specific objectives for management bodies and individual lines of responsibilities are clearly specified. Money managers are strongly held accountable for performance. Performance indicators are clearly written and used in regular performance management. Fund management functions are separated from policy setting functions.

2. Institutions managing public environmental expenditure do not waste public money by supporting projects that can be implemented without public funds. Financial support is limited to what is necessary to make the project financially viable to beneficiary given prevailing market conditions. To this end subsidy equivalents in all financial instruments are regularly calculated and disclosed.

3. Institutional development and strengthening is incorporated into the design and incentive structure of the organization managing public money for environmental purposes.

4. The amount of resources and the sophistication of operations and disbursement instruments is proportional to the institutional capacity to manage the associated risk. Typically, grants are used first. As in-house capacity to manage financial risk increases other financial products are consecutively explored in the order of increasing risk: interest subsidies, indirect loans, leasing, direct loans, equity investments, loan guarantees. Before new financial product is applied, its feasibility is checked by a market needs assessment and business plan.

5. External entities (e.g. commercial banks) may be contracted to provide certain services, such as loan management, risk assessment and coverage, creditworthiness analysis. This outsourcing should always be conducted through a competitive process and re-tendered periodically.
LITERATURE


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