ENVIRONMENT DIRECTORATE
ENVIRONMENT POLICY COMMITTEE
TASK FORCE FOR THE IMPLEMENTATION OF THE ENVIRONMENTAL ACTION
PROGRAMME FOR CENTRAL AND EASTERN EUROPE, CAUCASUS AND CENTRAL ASIA

MAINSTREAMING ENVIRONMENTAL PROGRAMMES INTO PUBLIC BUDGETS IN EASTERN EUROPE, CAUCASUS, AND CENTRAL ASIA (EECCA):
SUMMARY OF PRELIMINARY RESULTS FROM A REGIONAL SURVEY

Annual Meeting of the Task Force for the Implementation of the Environmental Action Programme for Eastern Europe, Caucasus and Central Asia (EAP Task Force)

14-15 October 2010, Almaty, Kazakhstan

Agenda item: 9

This paper briefly introduces the preliminary findings and policy messages emerging from a survey on mainstreaming environmental programmes into public budgets in Eastern Europe, Caucasus and Central Asia (EECCA). The paper is based on the analysis developed in a more detailed technical report which will be discussed at an expert meeting with representatives of EECCA ministries of environment and finance in Riga, Latvia, in November 2010.

ACTION REQUIRED: For discussion. Written comments can be provided by 31 October 2010.

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Mainstreaming Environmental Programmes into Public Budgets in Eastern Europe, Caucasus, and Central Asia: Summary of Preliminary Results from a Regional Survey

1. This paper summarises the major findings and policy recommendations emerging from the recent OECD/EAP Task Force work on public environmental financing, which is detailed in a more extended report under the title “Mainstreaming environmental programmes into public budgets”. The latter report will be presented and discussed at a joint meeting of ministries of environment and finance from Eastern Europe, Caucasus and Central Asia (EECCA) and their OECD and Central European partners on 8-9 November 2010. It is one of the three flagship reports that the EAP Task Force is preparing for the Astana Ministerial Conference in 2011. The report continues the suit of products that the OECD has developed in support to reforms of public environmental expenditure\(^1\) management in EECCA. The governments of the Netherlands and Switzerland provided financial support for the project. Their contribution is gratefully acknowledged.

I. Context, objectives and scope of the OECD analysis of “environmental finance integration”

2. As the effects of the global financial and economic crisis are having a growing impact on public budgets, and as donors shift to delivering aid via more robust, reliable and transparent country systems, the environmental sector in EECCA becomes increasingly vulnerable to underfunding. In this context, the OECD/EAP Task Force has both continued its past analytical work to monitor the extent and roots of the limited financial sustainability exhibited by the environmental sector in EECCA, and launched new work aiming to clarify the sector’s ability to respond to an ever increasing in-country competition for budgetary resources and its integration not only in national-level strategies and plans, but also in related annual budgets.

3. This work took the form of a regional survey, involving ten EECCA countries that volunteered to put their own resources (both on the side of ministries of environment as well as ministries of finance) into this joint undertaking, namely: Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, the Russian Federation, Ukraine, and Uzbekistan. A key objective of this survey was to analyse whether policy, legal, organisational and knowledge-related preconditions for achieving the financial sustainability of the environmental sector are in place in the participating countries. The survey was designed along the main directions of public finance management reforms in the region, reflecting, in particular, the shift towards budgets based on medium-term expenditure frameworks (MTEFs). In its most advanced form, MTEF is a tool that helps public authorities to structure the budget around programmes that are developed in line with policy objectives and linked to specific outcomes, thus aiming to integrate policy, activity planning and annual budgets.

4. Although adopted from a wider public sector reform perspective, this new way of planning is particularly suited to the needs of the environmental sector. As OECD practice testifies, the long-term nature of some environmental policies and infrastructure development needs clearly benefit from the stability created by MTEFs. More generally, financially sound environmental programmes stand a better chance of obtaining adequate funding. Even when there is a need for budget cuts, such programmes will suffer less damage, particularly if their policy relevance is well-documented.

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\(^1\) For the purpose of this paper, “public expenditure” is expenditure incurred directly or indirectly by government units. “Government” is understood as “general government”, unless otherwise stated. According to the System of National Accounts, “general government” is the grouping of government units at different levels: central, state (in federalist countries), local authorities and government-financed social security funds. Government units also include extra-budgetary funds, non-profit institutions which are wholly, or mainly, financed by the government, and government enterprises involved in production for the government.
5. It has to be stressed that the relevance of public support for environmental programmes does not fade in EECCA even if the region is gradually reducing the size of its formerly huge public sector. On the contrary, the persistence of past policy failures (such as, for instance, historic industrial and agricultural pollution), the mounting problems linked to climate change, or a whole range of market limitations and failures (such as high costs of borrowing, inadequate price signals, poor base for sustainable cost recovery of environmental services, etc.) make public environmental expenditure crucial for addressing environmental issues and, more broadly, promoting a greener model of development.

II. The applied analytical framework and the process of report development

6. The OECD secretariat has started the survey process by applying an overall analytical framework. Based on international benchmarks, which are not environment specific but are relevant to the whole public sector, the major questions to be addressed were identified for a small number of key areas of reform, which are as follows:

- **Policy drive behind budget allocation**: Do strategic priorities drive budget preparation? Are they revisited during this process?

- **Intra-government coherence and fiscal discipline**: Is there a unified “whole-of-government” approach that encompasses all sectors? Is a “top-down” hard budget constraint provided to line ministries? Does this budget constraint ensure macroeconomic sustainability by limiting overall levels of spending over the medium-term?

- **Sectoral ownership**: Is the “bottom-up” costing of policies and programmes applied?

- **Consistency of implementation**: Does a strong and clear link between MTEF projections and the annual budget exist? Has a single political process been put in place to reconcile the bottom-up and top-down components of the resource allocation decisions?

- **Procedural soundness**: Has the government developed a set of clear and robust procedures, rules and criteria for identifying and selecting projects that will be financed from medium-term programmes?

- **Availability and use of tools in support to evidence-based decisions**: Is budget allocation based on expenditure reviews and other studies?

- **Transparency and accountability**: Are accountability rules relying on monitoring and evaluation of results (i.e. outputs and outcomes) rather than on financial inputs?

7. The above “checklist” was then used to prepare a detailed survey questionnaire, which was discussed and agreed with participating countries at a meeting in June 2009. Data collection was carried out by civil servants from EECCA countries, the whole set of responses being available to the Secretariat in February-March 2010. Data verification and collation took some three months, while the report drafting was done in parallel with this process in the period October 2009-September 2010.

8. Given the EAP Task Force’s mandate to work mostly with environmental ministries, the survey, unfortunately, did not involve line ministries that may have environmentally-related programmes. Involving other government stakeholders would clearly benefit the soundness of analysis and should be envisaged in the future. Another problem linked to the relatively early start of the survey is the cut off date for the most of financial data – the end of 2008, which may have made public expenditure information overly optimistic in comparison with its current state, after public finances were hit by the crisis.
III. Target audience and structure

9. The report was designed to satisfy the interests of a very diverse audience. Primarily, it focused on political staff and civil servants from ministries of environment who need to enhance their knowledge and understanding of modern budgetary systems in order to be able to effectively communicate with peers in central planning (finance and economic affairs) ministries. At the same time, the report aims to inform staff from the latter ministries, as well as other government and parliamentary officials about challenges faced by the environmental sector. Another target group are donors who, despite moving to direct budget support, would like to ensure that the environment sector is not marginalised in the process of budget allocation. On the whole, the report may be used as a basis for discussion and consensus-building within the national governments and internationally on making public environmental expenditure management a real tool for promoting environmental improvements in EECCA.

10. The report is divided into two parts, including a comparative analysis (Part 1) and country profiles (Part 2). Part 1 is composed of seven chapters, each addressing the following issues:

- The methodological aspects of reviewing the “environmental fiscal and budgetary integration” in EECCA;
- The state of public environmental finances in EECCA;
- Drivers that are behind the transition to medium-term budgeting;
- The progress in reforming public finance management systems in the region;
- The challenges of increasing financial sustainability within the environmental sector; and
- Findings and recommendations.

A companion policy brief will be developed after the report is finalised.

IV. Major conclusions and recommendations arising from the survey

12. While the OECD secretariat is still implementing the last round of consultations with countries to validate the results of the study, the major conclusions and recommendations are already shaping up quite clearly. The secretariat’s assumption at the start of this work, that EECCA countries may have rudimentary systems in support to multi-year budget planning, turned to be false. Most of these countries adopted MTEFs within a surprisingly short period, and with a very comprehensive scope. The devil is, as usually, in details.

Progress on enacting reforms of public finance management (PFM) in EECCA is significant…

13. On the whole, the national budgets in EECCA countries have become more comprehensive, based on more realistic macroeconomic assumptions, and more transparent than in the past, owing to significant progress in the reforms in the public finance management that these countries put in place. Some of these reforms have been driven by international financing institutions but in some countries (e.g. Russia) they have been a result of a genuine willingness of the government to strengthen fiscal discipline and improve the management of public finances. Progress in consolidating various types of government resources (extra-budgetary funds, public investment programmes, and quasi-fiscal activities) into budget documentation going through legislative scrutiny and in introducing treasury systems and single treasury accounts is also visible. Most of the surveyed countries introduced a full classification of government revenues and expenditure by economic, functional, organisational, programme and funding codes. This facilitates the analysis of social and economic effects of government revenue collection and spending policies. These reforms were further
consolidated in comprehensive Budget Codes, adopted by many of the countries, which also introduced a number of modern budgeting concepts and practices, such as MTEF and performance-oriented budgeting.

14. Seven countries in the region have already introduced MTEFs, in one form or another. These include: Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, and the Russian Federation. The MTEFs in these countries (except Russia) are rolling frameworks revised annually. Kyrgyzstan has the longest experience with preparing MTEFs, as it launched its first one in 2001, and Kazakhstan – the shortest (since 2009). Belarus is preparing its first medium-term framework which will be launched in 2011 and will cover the period 2011-2013. Ukraine and Uzbekistan have not developed MTEFs but have introduced certain MTEF elements in their budgeting practices (programmatic budgets in Ukraine and medium-term macroeconomic projections in Uzbekistan).

15. The Russian Federation is a special case with not just a loose expenditure framework: Russia has gone a step ahead and has introduced 3-year budgets. Strictly speaking, very few of the OECD countries have ever worked with more than annual budgets, as legislatures are not constitutionally allowed to raise taxes or approve appropriations for a longer period than one year. In this context, it will be interesting to follow Russia’s experiment and to learn from it.

16. In terms of MTEF coverage, five countries report full coverage (Georgia, Kazakhstan, Kyrgyzstan, Moldova, and Russia) that is, all levels of government and all sectors are included in the MTEF, while Armenia and Azerbaijan report that MTEF applies to central government bodies only. The same five countries report that from the outset MTEF was introduced as a whole of government exercise, implying that ministries of environment were part of this process.

17. Almost all countries in the region prepare some medium-term macroeconomic and fiscal projections, those who have IMF-supported programmes seem more likely to update them. To strengthen budget discipline, many countries have started introducing fiscal rules and top-down expenditure ceilings on initial ministries’ allocations. Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova report such fixed limitations or hard budget constraints for individual government bodies. In addition, most countries report that the MTEF/budget process has been increasingly made more policy oriented and national procedures have been put in place to guide and coordinate the MTEF/annual budget process. Some countries (e.g. Armenia, Georgia, Moldova, the Kyrgyz Republic) have put in place institutional arrangements to guide and coordinate the process of MTEF preparation (sector working groups).

18. In addition, Georgia, Kyrgyzstan, Uzbekistan and Ukraine have introduced programme budgeting. Obviously, programme as well as performance-based budgeting can be introduced independently from an MTEF process but, in reality, it makes little sense to prepare such a heavy exercise within the limits of one year only. Also, most countries have introduced some kind of performance indicators or targets but these are mostly related to financial information and serve little purpose in the resource allocation negotiations.

…but the adoption of MTEFs has hardly changed the political stance of budgetary processes

19. Legislative reforms have been conducted to mandate the use of MTEFs. The main issue is how these reforms are translated into the real (political) life. By and large, it seems that they have been implemented as a condition by donors and International Finance Institutions (IFIs) granting support to the countries. Policy makers and parliamentarians rarely use macro-economic projections or performance information in their debates on policy priorities. The MTEFs are developed but not endorsed by parliaments. Often there are no clear links between the MTEF and the annual budgets. In sum, there is little real demand for these modern budgeting practices on the part of politicians.

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2 A multi-annual constraint on a fiscal aggregate (e.g. expenditure, revenue, budget balance or debt). It is typically defined in terms of an indicator of overall fiscal performance, such as the deficit/GDP ratio or the debt/GDP ratio.
On the other hand, preparing a full-fledged MTEF is a resource consuming exercise and if the government is going to take a formalistic approach to its results, this will bring frustration and cynical attitude in staff and will be just a waste of money. There is some anecdotal evidence that this might be the case in some EECCA administrations. As long as parliaments and ministers do not seriously consider the medium term costs of the programmes in their policy and budget allocation debates, the MTEF will remain a technocratic exercise of little practical value.

Meanwhile, the financial sustainability of the environmental sector is further eroding

During the three years that preceded the crisis in EECCA, in absolute terms, domestic public support to the environment sector was generally increasing in four of the countries that provided data (Armenia, Belarus, Moldova, and Russia). However, as a share of GDP, public environmental expenditure was generally decreasing (except in Azerbaijan and Uzbekistan). The share of the reported public environmentally-related expenditure in GDP varies significantly across the above 6 countries, from 0.02% of GDP in Uzbekistan in 2006 to 0.81% of GDP in Belarus (in 2006), which has the highest public environmental expenditure among the surveyed countries. These data should be treated with caution, as it is not clear how exactly countries define public environmental expenditure and if data cover expenditure at the national level only or at the local level as well.

It has to be noted that the public sector should not be the only source of environmental investments in EECCA. The implementation of the Polluter-Pays and User-Pays Principles suggests that business and consumers should have an important role in financing environmental expenditure, particularly as public investment declines. Unfortunately, it was not possible to collect data on private sector environmental investments through this survey. It is likely however that generally the private sector is not the major financier of environmental investments in these countries.

In addition, the budgets of the environmental ministries, although increasing over the years of economic growth, remain negligible in comparison to other “non-economic” sectors, such as health and education. As a share of total government budgets, environmental authorities’ budgets range between 0.85% (the highest) in Georgia to 0.11% (the lowest) in Uzbekistan.

This picture may be more nuanced, however, since environmentally-related spending is spread over a large number of sectors. Further analysis, involving line ministries, can shed light on the real picture of environmental expenditure. Together with the transition to the green growth model of development, this exercise can become even more complicated due to the lack of clear “borders” of green growth, on the one hand, and the traditional perception of environmental action as pollution abatement.

Most of the public resources of the environmental administrations go either to nature protection and conservation (Armenia and Moldova) or water resources protection in Belarus. These countries spent most of the resources on supporting current expenditure rather than investments. Russia, and particularly Uzbekistan, made very little or almost no new public environmental investments in the period 2006-2008.

In general, access to finance for environmental investments in EECCA is limited. Domestic capital and financial markets are weak and borrowing is expensive, hence the role of the domestic financial sector in environmental investments is negligible in most EECCA countries. Public support, including from extra-budgetary environmental funds (where these exist) and donor aid, remain significant sources of finance for environmental investments in some, though not all, EECCA countries. Carbon finance, for both mitigation and adaptation, is a potentially important new source of finance for environmental expenditure that EECCA countries need to exploit more consistently.

…and public environmental expenditure remains extremely opaque and fragmented

One particular issue that needs special attention is the lack of (reliable) data. A number of countries were not in a position to provide sufficient public expenditure data and information and this raises concerns
about the quality, sustainability and credibility of the environmental programmes prepared and supported by the environmental administrations. Without such basic data and understanding of what is generally financed at the national and local level, ministries of environment can hardly design programmes which will complement other funding sources. Problems like this become further magnified within the framework of medium-term expenditure planning where well-costed programmes are essential.

**Because of limited capacity, the environmental sector benefits only marginally from PFM reforms**

28. MTEFs have been introduced as a whole-of-government approach and the ministries of environment have been fully integrated in this process. While most of these ministries have extensive experience with preparing strategies and policies, their programmatic skills seem to be much lower. A lot of ministries’ staff are involved in preparing programmes, including for inclusion in the MTEF process, but there is often little understanding of what this exactly implies. All countries have prepared numerous programmes, particularly the so-called targeted environmental programmes, but these are rarely properly costed or supported by financial strategies, market studies or feasibility analysis. Analytical tools, such as costing or cost-benefit and cost-effectiveness evaluation models, are rarely used in the programming process. Programme estimates are not sufficiently robust, the fiscal impact and economic implications of such programmes are not always clearly identified. Hence the habitually poor link of these estimates with the annual budget allocations.

29. Programmes often lack clear and measurable environmental targets, performance indicators (particularly for the investment part) are not consistent across the years of programme implementation. Generally, only investment data are calculated, operation and maintenance costs are not considered. Thus, environmental programmes have often little credibility

30. Unfortunately, the reality is that even if other, more powerful, ministries are not particularly better in preparing programmes, because of political priorities, these other ministries are in a position to obtain more adequate level of resources. Therefore, the best way for EEECA environmental authorities to overcome this obstacle is by developing their capacity to design, cost and defend their programmes on both environmental and economic terms and in line with good international practices. While it should be recognised that the budget process and resource allocation decisions are in large part of political nature, with or without an MTEF, the relatively low capacity of the environment ministries to prepare, cost and implement economically-sound multi-year programmes may have been one of the reasons for a low budget support for the environment. The absence of sound programming could contribute to a further marginalisation of environmental activities in the governments’ agenda. At the same time, preparing a well-designed environment programme, consistent with MTEF requirements, is not a guarantee of increased financing: it is a necessary but not sufficient condition.

**Procedural and organisational problems are likely to limit the finance absorption capacity of the sector**

31. Several ministries of environment report that they have not been able to spend even the little resources which they obtained from the budget. This may imply some problems with expenditure management practices. Only Armenia, Kazakhstan and Russia have dedicated staff responsible for working on MTEF preparation and coordination. In the rest of the countries, these functions are fulfilled by regular staff who do this work along with their routine responsibilities.

32. The management of investment projects is particularly weak in EECCA countries. In general, there are no robust procedures, rules and criteria to support the project cycle. The appraisal and selection criteria are rather basic. Cost-effectiveness is not a prominent criterion in the appraisal of projects so it is not clear if the most cost-effective projects are selected to receive public support. The fact that most countries do not have dedicated staff to manage (appraise, select and monitor) investment programmes and projects on a daily, routine, basis prevents the development of a critical mass of skills in the institution as well as project preparation capacity in the countries, for that matter. The poor management of public environmental expenditure programmes leads to further dissipation of public funds, and weakens the claim of environment ministries for maintaining or increasing their budget allocation. In consequence, there is a need to continue
improving the programming, project preparation, and environmental expenditure management practices in EECCA in line with good international standards.

**The shift in donor financing approaches may bring new opportunities, but there is a risk of a further marginalisation of the environmental sector**

33. In terms of donor financing, direct budget and/or sectoral support is being more widely used by donors and is replacing project financing. For example, direct budget support provided to Moldova in 2008 represented about 50% of all donor support and in a period of 3 years, between 2006 and 2008, it increased more than 6 times. In Armenia, all possible forms of donor support are co-existing, project and programme financing, sector wide and direct budget support. In the period 2006-2008 however, direct budget support actually decreased as a share of total donor contributions (from 21.3 to 14.3%). Therefore, it is difficult to make any strict conclusions on the basis of the limited data provided in the survey questionnaire by the countries. However, OECD data show that over the past years donors like France, Germany, UK have started using this aid instrument on a regular basis.

34. This shift in donor support practices imposes new challenges to the ministries of environment in the competition for public resources. Unless ministries of environment improve their expenditure management practices, they risk to remain marginalised in this process and lose access to donor resources. Donors, on the other hand, can contribute to good public governance by supporting policy dialogues and actively participating in sector working groups which are responsible for sectoral MTEFs preparation.

35. Carbon financing, along with the budget and extra-budgetary environmental funds, is gaining place among the environmental funding sources. As a share of total donor financing, carbon financing has also been generally increasing in the recent years. In Armenia, for example, carbon financing (mitigation and adaptation) has significantly increased between 2006 and 2008 – more than two times. It has to be noted though that there will be a lot of competition for resources coming from carbon funds which also makes the case for improved financial planning, if the environment sector would want to get access to this source.

**Developing technical expertise and promoting further transparency are crucial**

36. Technical expertise in the preparation of programmes, setting targets and performance indicators and in improved project cycle management can equip ministries of environment with knowledge and skills that would make them more competitive. Donors have a crucial role to play in supporting such methodological and capacity building work in the countries.

37. The neutrality of the MTEF process with regard to individual sectors introduces a level-playing field that EECCA environmental ministries may be able to benefit from should they aim to change their traditional way of preparing their medium and long term programmes and annual budgets. Donors can be instrumental in supporting countries which are willing to improve their public environmental expenditure management practices. A crisis period is often a good time to introduce and strengthen multi-year budgeting. This can help consolidate public budgets and better target policy actions as well as provide healthy public finance for the economy after the crisis is over. The governments and the legislatures need to create further demand for good practices in public expenditure management, including in the environmental sector, should the countries choose to improve their public finance systems and bring them closer to international standards.

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3 Direct Budget Support (DBS) refers to aid channelled directly to government budgets, to be disbursed using their own allocation, procurement and accounting systems. It is important to note that DBS does not just involve the transfer of funds; the approach has three key elements: technical assistance or capacity building, policy dialogue and the transfer of resources.
Analytical tools for greening MTEFs are needed

38. Ministries of environment jointly with the ministries of finance and economy need to prepare a government-wide methodology for assessment of the MTEF process that will cover all environmental programmes prepared by different government agencies. They need to introduce clear rules and procedures for mid-term reviews of the programmes and possible ways for adjusting them as well as clear lines of responsibility for all actors involved in the implementation of the programmes. This may help overcome the fragmentation in the environment sector.

V. Future work on integrating the environmental sector into medium-term expenditure frameworks

39. While the work on mainstreaming the environmental sector into medium-term budgetary processes is still at a rather early stage of development, the EAP Task Force and donors, together with selected countries, are exploring possibilities, albeit limited, to move this process forward. For example, the EAP Task Force together with Sweden is designing a training course on medium-term expenditure planning for environmental ministries in EECCA which will be delivered on a pilot basis in Armenia. A methodology for programme design and costing is being developed and will be pilot tested in Kazakhstan. The purpose of this work is to assist the Kazakh Ministry of Environment to prepare a priority climate change programme in line with good international practices and estimate its costs with the aim of obtaining adequate budget and donor financing for its implementation. These projects could be replicated in other countries, should there be sufficient interest by other ministries of environment.

40. Beyond the Astana Ministerial in 2011, work on medium-term budgetary planning in the environment sector could be further extended and focused to cover specific issues. One potential area to explore, more on the revenue side, is greening the budgets in EECCA and green tax reforms with a focus on eliminating environmentally-harmful subsidies. On the expenditure side, it may be worth studying the cost of inaction in the environmental sector and its implications on future public budgets. In any case, there will be a need to even more closely involve ministries of finance and other relevant institutions in this work in order to ensure that the messages are taken up in the key ministries and inter-ministerial forums. This work can help address issues related to the transparency of public environmental expenditure management and the fragmentation of environmental budgets in the framework of medium-term budgetary processes.

41. At the annual meeting of the Regulatory Environmental Programme Implementation Network (REPIN) in Riga, in November 2010, representatives of the ministries of environment and finance will have the opportunity to discuss how to further strengthen their interaction and cooperation on these issues. They will also have a possibility to propose ideas of possible future work in this area and discuss their relevance for the region with their peers from the other EECCA countries.