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GOOD PRACTICES OF PUBLIC ENVIRONMENTAL EXPENDITURE MANAGEMENT IN TRANSITION ECONOMIES

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BACKGROUND DOCUMENT



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EXECUTIVE SUMMARY

1. The Good Practices of Public Environmental Expenditure Management (PEEM) build upon and update the *St. Petersburg Guidelines on Environmental Funds in the Transition to a Market Economy*; the *St Petersburg Guidelines* had become an internationally-acknowledged framework for evaluating the performance of public environmental funds since their endorsement within the “Environment for Europe” process in 1995. The Good Practices of PEEM apply to all agencies and programmes managing public environmental expenditure programs, including environmental funds. They draw on both positive and negative experiences in OECD countries and transition economies and provide a framework for mainstreaming environmental expenditure programs in the core of public finance. The Good Practices of PEEM are intended mainly to meet the needs of countries undergoing transition to a market economy.

2. The Good Practices provide guidance on how to design and implement public environmental expenditure programs. They address the principles, procedures and organizational frameworks that are likely to be most acceptable for Ministries of Finance and foreign sources of financing. They also address the some of the key policy issues in managing public environmental expenditures, such as earmarking, the consistency of extra-budgetary (environmental) funds with public finance principles and the rationale for providing environmental subsidies in relation to the Polluter-Pays Principle. The Good Practices have been developed through a series of international consultations with various stakeholders from the EECCA, CEE and OECD countries and international financial institutions.

3. The Good Practices help evaluate how a public environmental expenditure programme performs. The performance is measured along three dimensions: environmental effectiveness, fiscal prudence and management efficiency. The *environmental effectiveness* dimension measures the performance of public expenditure programs as instruments for achieving environmental goals. *Fiscal prudence* measures the alignment of environmental expenditure programmes with the principles of sound public finance. *Management efficiency* measures how efficiently and professionally financial and human resources are utilised. All three dimensions of good practices of PEEM are operationalised in the form of self-explanatory checklists. The results of performance assessments are visualised in a chart that plots the score on each of the performance dimensions. The OECD/EAP Task Force secretariat has used this methodology to review and evaluate the performance of some environmental funds in CEE and EECCA countries.

4. Without prejudice to country-specific fiscal, economic and institutional conditions, the document provides a generic "road map" for implementation of the Good Practices of PEEM. This road-map begins by defining specific, priority environmental objectives. It recommends that a careful assessment be made of the need for public expenditures to achieve these objectives. The next proposed step is to define sources of funds, the size of the financial envelope and, above all, the main elements of an expenditure program (such as specific objectives, cost estimates, description of eligible project types and beneficiaries, terms of financing, procedures, principles and criteria of project appraisal and selection, procurement rules, time frame, indicators of performance). Having done this, environmental authorities are ready to select the best institutional arrangement (implementing agency) for managing the expenditure program and ensuring compliance with good practices of PEEM by applying checklists.

5. *Environmental authorities* can use the Good Practices of Public Environmental Expenditure Management as a framework for designing effective environmental expenditure programs and institutional modalities for their implementation. *Public and private implementing agencies* bidding for the management or already managing public environmental expenditure program can use these Good Practices as guidance to improve the quality of their performance. The proposed methodology is easy to use and

could also be applied for self-assessment. *External auditors and potential investors* can use the Good Practices of PEEM to evaluate the performance of implementing agencies as well as their supervising government structures.

1. INTRODUCTION

6. During the past ten years, the countries undergoing transition to a market economy in Central and Eastern Europe, the former Soviet Union and Asia have all struggled to achieve macroeconomic stabilisation and fiscal consolidation albeit with different degrees of success. They have recognised the importance of establishing a healthy and sound system of public finance, as a cornerstone of social well-being and sustainable economic development.

7. The goals of macroeconomic stabilisation and solid fiscal position of the public sector are not part of the mandate of environmental policy. Its main objective is to provide another cornerstone of social well-being and sustainable economic development, namely high quality of environmental goods and services. Because of external effects involved and their public good character, environmental goods and services often do not enjoy an economically efficient level of financial support by private markets. Thus, governments have the indispensable responsibility to finance environmental public goods and correct external effects. However, environmental constituencies (environmental government agencies, NGOs, environmental service businesses) are often not effective in the budget process because they are perceived as representing an excessively parochial, “demanding” position which may be dysfunctional with respect to the overall government’s and society’s effort to achieve macroeconomic and fiscal stability. This document originates from the hypothesis that the public agencies managing environmental expenditure in transition economies might be more effective in attracting government resources and foreign finance if they operated according to acknowledged standards of sound public finance. Environmental policy (and indeed any other line policy), which obstructs the goals of the rest of government, is bound to be marginalized. Environmental agencies face a challenge of mainstreaming environmental expenditure programs in the core of public finance.

8. As the experience of some countries shows, it is possible to design and implement public environmental expenditure programs in such a way that they would be welcome by fiscal authorities. The “Good Practices of Public Environmental Expenditure Management” (PEEM) proposed here draw from both positive and negative experiences with different public environmental expenditure programs in the OECD countries and transition economies. This document is intended to support a sound integration of environment into public finance priorities. It focuses on the expenditure, and not on the revenue side of public environmental finance.

9. The Good Practices of Public Environmental Expenditure Management have emerged from several earlier initiatives related to good practices in general public expenditure management of the OECD (including EAP Task Force), the World Bank and Asian Development Bank. ((Allen, Tomassi, (2001), Sciavo-Campo, Tomassi (1999), World Bank (1998)). They were first drafted at the OECD Secretariat of the EAP Task Force in 2000. Since then, they have gradually evolved through a series of international consultations involving the OECD EAP Task Force Environmental Finance Network, the OECD Global Forum on Sustainable Development, the World Bank, various financing institutions, as well as several individual practitioners and experts. In May 2003, the Good Practices they are submitted for endorsement by the Ministerial Declaration at the "Environment for Europe" Ministerial Conference in Kyiv.

2. TARGET AUDIENCE OF THE GOOD PRACTICES OF PUBLIC ENVIRONMENTAL EXPENDITURE MANAGEMENT (PEEM)

10. *Environmental authorities* can use the Good Practices of Public Environmental Expenditure Management (PEEM) as a framework for designing successful environmental expenditure programs and choosing the right implementing institutions. They can also be used to review -- and if necessary reform -- public or private agencies entrusted with the task to implement public environmental expenditure programs.

11. *Public and private implementing agencies* bidding for the management or already managing public environmental expenditure program can use these Good Practices as guidance to improve the quality of their performance. The proposed methodology is easy to use and could also be applied for self-assessment.

12. *External auditors and potential investors* can use the Good Practices of PEEM to evaluate the performance of implementing agencies as well as their supervising government structures.

13. The Good Practices of PEEM were put together mainly to meet the needs of countries undergoing transition to a market economy. They are targeted at the countries, where public funds are relatively scarce and public resources are used both to provide environmental public goods and as an incentive to undertake environmental improvements by public and private economic agents.

3. INSTITUTIONAL ARRANGEMENTS FOR PUBLIC ENVIRONMENTAL EXPENDITURE MANAGEMENT

14. Environmental departments of the Government at different levels can choose from a wide variety of different institutional arrangements to implement any environmental expenditure program. Both public and private agencies can be contracted to perform this task. The choice of the institutional set up should be tailored to the specific needs of a given expenditure program. Depending on these needs, one or a combination of many of the options listed below can be chosen:

- *Government department* (at a different level) responsible for direct purchase of goods and services or for financing of specific projects included in the budget.
- *Project implementation unit* established within a government department in order to implement a specific government expenditure program included in the budget.
- *Autonomous/decentralised 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 organised along these lines).
- *Public utility* with the authority to collect user charges and the 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 co-financed by transfers from the general budget. Some environmental funds in the CEE

and NIS countries belong to this category. Other examples include road funds, disability trust funds or social security funds.

- *Budgetary fund managed outside 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 the government varies from country to country, ranging from specialised teams within the government department to autonomous institutions. Several environmental protection funds in the CEE and NIS countries fall 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 programs 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 the 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 capitalised by discrete, one-time budgetary transfers (e.g. formerly the Slovenian Environmental Development Fund).
- *Independent intermediary for the government (grant or debt) expenditure program*. The intermediary bears a contractual obligation to disburse government resources on terms and conditions specified in the agreement with the government. Such expenditure programs are usually funded by discrete budgetary transfers, but can also be contracted by special purpose fiscal units, autonomous agencies or autonomous funds. Many different types of institutions may act as intermediaries. 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 the implementation of government expenditure programs. The range of services provided by the private sector may be very wide, extending from selected elements of project appraisal to full financial intermediation for loan and grant financing (with or without co-financing), or concession for project implementation and operation.
- *Government-(co-)owned public fund established to manage expenditure programs co-financed from external loans or grants*. The legal status can take the form of a trust fund, a foundation, an association or a commercial code company. Such funds usually receive matching financing from the general budget or from specific domestic revenue sources. External financiers usually require a significant degree of managerial autonomy and insulation from politics. The Polish and Bulgarian debt-for-environment swap funds belong to this category.
- *Directed credit funds* (DCFs) established as financial intermediaries by either government donor organisations or the International Financing Institutions (IFIs), such as the World Bank. They are designed to finance small commercial or municipal pollution abatement projects by avoiding the cost of direct financing. DCFs typically operate on a revolving basis, often for a predetermined period corresponding, for example, to the disbursement period of IFI or donor lending. They are commercial institutions with strong development goals. (Lovei, 1999).
- *Counterpart funds* generated by sales of commodities or services provided through official assistance. They are managed under specific procedures and take into account the requirements of the donors.

4. HISTORICAL ISSUES IN PUBLIC ENVIRONMENTAL EXPENDITURE MANAGEMENT

Earmarking

15. Environmental authorities have traditionally advocated earmarking of revenue from environmentally-related charges for financing environmental projects either through general budgets or through public environmental funds (budgetary or off-budgetary), controlled by the Ministries of Environment. This has often driven environmental authorities into conflicts with fiscal authorities and their foreign advisers (such as IMF). It is widely acknowledged that earmarking limits flexibility and thus, potentially, the efficiency of allocation of resources to the most socially-needed uses. In addition, it creates precedence and gives rise to the claims of other government agencies (e.g. those, which deal with forests, water, agriculture, education, etc.) for the right to have their own earmarked funds. This may lead to a budget fragmentation, making the economy impossible to manage. But under specific conditions earmarking is often perceived as a price worth paying for having predictable financing for priority environmental measures that would otherwise fail (World Bank et al., 2002). On the other hand, empirical evidence shows that earmarking by itself has not protected the decline of public environmental expenditure. Indeed, in some cases, earmarking may have contributed to the further marginalisation of environmental expenditure within public budgets. Ministries of Finance tend to reduce the budget envelope of Environment Ministries, if the latter already have their own, independent, earmarked sources of revenue.

Public Environmental Funds

16. The Principles of PEEM have been derived from the principles of public expenditure management (PEM) developed in the literature of the OECD (PUMA, SIGMA), the World Bank and the Asian Development Bank. The application of PEM principles to the environmental sector became particularly important in the 1980's and 1990's when the OECD countries first, and many transition economies later, embarked on large scale investment programs to develop environmental infrastructure. Because of the public good character of many of the environmental infrastructure services and externalities involved, public funds were involved on a massive scale to support these programs. This raised concerns about efficiency, effectiveness and fiscal prudence of these large scale government expenditure.

17. International efforts to define a set of minimum performance standards for public agencies managing environmental expenditure started in the 1990's, when the transition economies of Central Europe and the former Soviet Union re-entered the international democratic community with the legacy of earmarked public environmental funds, the size of which was of no precedence anywhere else in the world. In 1995, the "St. Petersburg Guidelines on Environmental Funds in a Transition to a Market Economy" were endorsed by the international Conference held in St. Petersburg under the auspices of the Task Force for Implementation of the Environmental Action Program for CEE (the EAP Task Force), supported by the OECD Secretariat. This meeting gathered policy makers and experts from Environment and Finance Ministries, top managers of environmental funds from both CEE and the former Soviet Union as well as representatives of the World Bank, the European Commission and donor agencies from several OECD countries. The Guidelines have been subsequently used to review the operations of existing funds as well as design technical assistance programs¹ for such Funds. The Guidelines have helped design and establish some new funds in the region as well.

¹ Using the framework of the St. Petersburg Guidelines, OECD and EC Phare experts conducted performance reviews of the Polish EcoFund (OECD/EU Phare, 1998), the Estonian Environmental Fund, the Czech State

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

- In order to avoid or minimise 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.
- Environmental funds should play a catalytic role in financing, ideally offering no more support for projects than is necessary; support provided should 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 strategy for financing agreed objectives, 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 program and project cycles to ensure the cost-effective use of resources.
- Environmental funds must not compete with emerging financial markets but should leverage financing from private sector enterprises, municipalities 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.

18. In the 1990's, the World Bank contributed significantly to the debate on performance standards for environmental funds and other similar institutions (e.g. Lovei, 1995, Lovei 1999, Travers, 1999). The Bank launched a series of public environmental expenditure reviews (PEER) of selected countries of operations and is now working on integrating them into the Bank's new analytical tool called Country Environmental Analysis (CEA) (World Bank publication forthcoming in 2003). The GEF's 1999 evaluation of "Experience with Conservation Trust Funds" set the standard by which environmental trust funds are evaluated in Africa, Asia and Latin America.

19. Eight years after the endorsement of the St. Petersburg Guidelines, the situation in transition countries has evolved considerably. At the beginning of a second decade of transition, it is unnecessarily restrictive to limit the debate to environmental funds only. Several environmental funds (particularly in EECCA countries) have already been consolidated into comprehensive budgets. The fundamental challenge is to look beyond funds and to mainstream various agencies implementing environmental expenditure programs in the public finance systems.

Polluter Pays Principle

20. Public expenditures may distort private markets. Therefore, the need for public financing of environmental investments in the business sector should always be carefully considered in light of the

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 Program for Central and Eastern Europe. See www.oecd.org/env/finance.

Polluter Pays Principle (the "no-subsidy" principle) that guides environmental policies in the OECD countries. Subsidies or soft financing should be used exceptionally and under specific, internationally-agreed conditions. Careful analysis of the scale and nature of the need for public funding by individual programs may help target subsidies better. In such instances, public spending on environment can bring genuine economic value-added where and when it is really necessary without obstructing the process of transition to an efficient market economy.

Box 2. The Polluter Pays Principle (PPP)

In the OECD countries, the underlying principle of environmental financing is the Polluter Pays Principle (PPP) which implies that polluters should bear the full cost of compliance with the goals established by the relevant administration *without subsidies*. Subsidies for the environment create perverse incentives because, in the long run, they tend to attract polluting industries, thus increasing rather than decreasing overall pollution. They also distort international trade and investments. Environmental subsidies also divert public sector resources away from those important social needs, which can not be financed from private sources.

The PPP, as it is applied in the OECD, provides for certain well-defined exceptions to its "no subsidy" philosophy. Specifically, a subsidy may be justified if it is well-targeted (i.e. the environmental objectives to be achieved by the subsidy are clearly specified), limited in size and duration and does not introduce significant distortions in markets and trade). It can also be used where considerable external benefits or provision of public goods are involved.

The development of an effective environmental finance system, based on the Polluter Pays Principle, is constrained during the transition to a market economy. This is due to several factors, including weak environmental management and enforcement, underdeveloped capital and financial markets, scarce private financing, uncertain political and fiscal systems and weak civil society.

5. BASIC PRINCIPLES OF SOUND PUBLIC FINANCE²

21. **Public expenditure management (PEM)** literature identifies a few essential goals of any sound public expenditure management system. It also identifies a set of universally applicable necessary conditions to achieve these goals. Together they establish a general framework for the sound public finance. Their application to environmental sector gave rise to good practices in **public environmental expenditure management (PEEM)**.

Three main goals of sound public expenditure management (PEM) systems

22. **Fiscal discipline**, efficient allocation of public funds, operational efficiency, accountability, transparency and comprehensiveness of the budget are internationally-recognised elements of sound public expenditure management and arguably the conditions for economic development to be sustainable. They establish framework conditions for sound management of public resources, which environmental or any other line agencies should not try to compromise.

23. **Fiscal discipline** 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

² Sources include mainly: Allen, Tommasi (2001), Schiavo-Campo, Tommasi (1999); World Bank (1998)

result in large, unsustainable deficits and an unstable macroeconomic environment. Fiscal discipline requires ceilings imposed on total public sector expenditure and on sectoral financial envelopes. Special care is required to control multi-year, explicit legal commitments, such as debt-servicing as well as implicit or contingent liabilities (e.g. guarantees).

24. **Allocative efficiency** means ensuring the best outcome by prioritising competing claims for 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 prioritisation. Central Ministers are in the best position to ensure efficient allocation of public resources among different sectors. 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.

25. **Cost effectiveness** implies achieving objectives at minimum cost. Cost-effectiveness tests are best applied when benefits are difficult to measure and value or when objectives have already been chosen. Contrary to allocative efficiency, cost-effectiveness is primarily a technical concept and always suffers from political influence. It requires managerial autonomy over the appraisal of specific projects and responsibility to implement defined expenditure programs subject to clearly defined accountability for performance. It requires competent individuals in the civil service attracted through adequate, performance-based compensation and a merit-based recruitment and promotion system.

Three necessary conditions for achieving PEM goals

26. **Transparency** 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 the public. Transparency requires independent assurance of the 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.

27. **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.

28. **Comprehensiveness of the budget**. Ideally all public sector revenues should be pooled together in a general fund, and the legislature, guided by the executive body, should allocate these common resources to public expenditure programs, so as to equalise the marginal social benefit for each program. Some economists, however, advocate earmarking and separate bargaining over earmarked tax-expenditure programs.

6. MAIN DIMENSIONS OF GOOD PRACTICES OF MANAGING PUBLIC ENVIRONMENTAL EXPENDITURE (PEEM)

29. The Good Practices of Public Environmental Expenditure Management (PEEM) build upon the basic principles of sound public finance outlined earlier, and adjust them to the specific needs and challenges of financing the environmental sector. Quality of public environmental expenditure management is considered in three dimensions:

- Environmental effectiveness;
- Fiscal prudence;
- Management efficiency.

30. The **environmental effectiveness** dimension measures the performance of public expenditure programs as instruments of environmental policy. **Fiscal prudence** measures the key aspects of alignment with the principles of sound public finance. **Management efficiency** measures how efficiently a financing institution utilises financial and human resources. Operational descriptions of all dimensions of good practices of PEEM are included in the checklists in Chapter eight.

7. GOOD PRACTICES IN DEVELOPING ENVIRONMENTAL EXPENDITURE PROGRAM

31. Different countries will follow different paths to implementing the Good Practices of PEEM. These paths will reflect different levels of economic and institutional development and maturity of markets and public finance systems. The following steps provide a generic "road map" for such implementation.

- ➔ **Define priority environmental objectives.** Specific, measurable, realistic and time-bound.
- ➔ **Determine if public expenditures are necessary to achieve these objectives.** If not, use other policy instruments, such as permits or taxes to achieve environmental policy objectives, saving public money for other uses. Move to the next step only if public expenditures are justified.
- ➔ **Define sources of funds, the size of financial envelope and an expenditure program.** An expenditure program should be an integral part of a larger environmental program aimed at achieving specific priority objectives. It should consist among others of specific objectives, cost estimates, description of eligible project types and beneficiaries, terms of financing, procedures, principles and criteria of project appraisal and selection, procurement rules, time frame, indicators of performance.
- ➔ **Select the best institutional arrangement for managing the expenditure program.** Simple expenditure programs (e.g. financing research or education, purchasing simple equipment or standard services) may be managed directly by assigning additional responsibilities to existing government institutions at different levels, using their regular staff and routine budget processes. For larger scale, more specialised programs, especially for programs that involve financing capital investments, special institutional arrangements

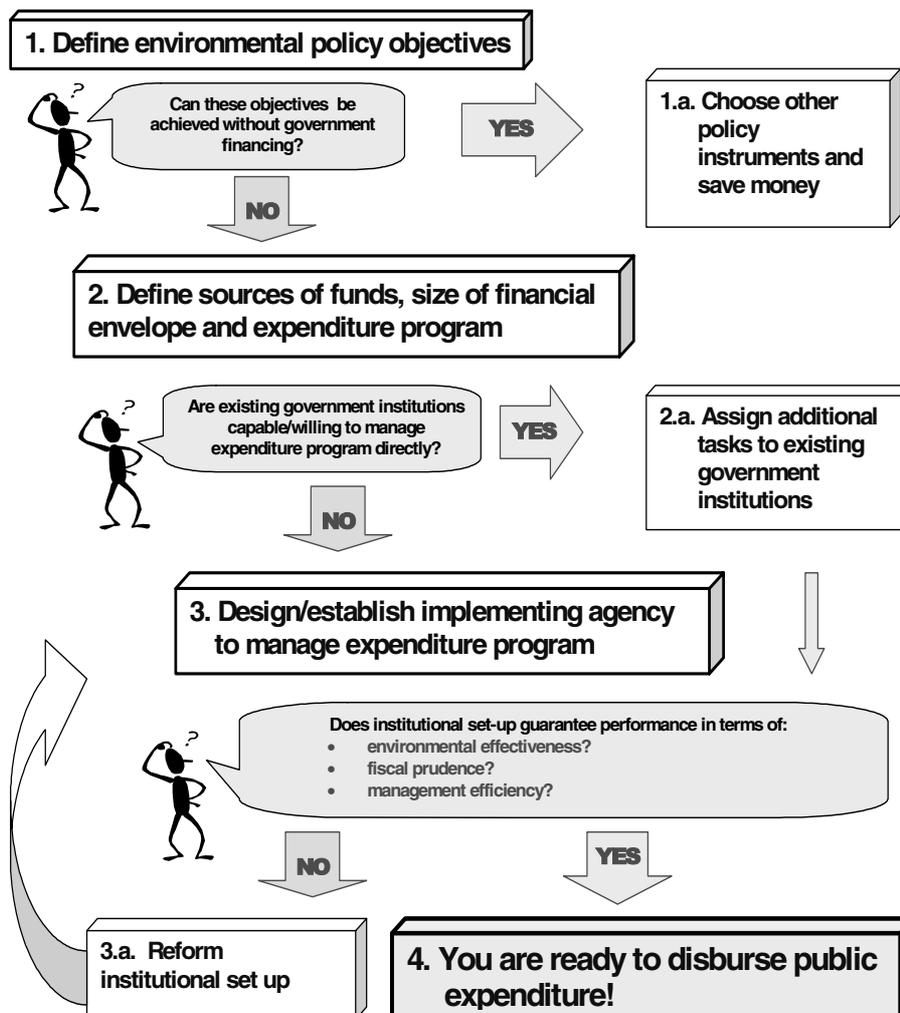
may be required. These special arrangements may take many institutional forms and involve various types of implementing agencies listed in Chapter 3. This can be a new department within the administration, a special public agency or earmarked environmental fund. It could also be a private institution (e.g. a bank) contracted for managing the expenditure program on behalf of the government.

→ **Contract and control implementing agency to manage the expenditure program.** Ensure compliance of all institutional arrangements with good practices of public environmental expenditure management. In order to do so, apply the following three checklists:

- Checklist for performance as an environmental policy instrument.
- Checklist for performance as instruments of public finance.
- Checklist for performance in terms of management efficiency.

This process is illustrated graphically on Figure 1 below.

Figure 1. Developing a Sound Public Environmental Expenditure Program



8. CHECKLISTS FOR MEASURING COMPLIANCE WITH GOOD PRACTICES OF PUBLIC ENVIRONMENTAL EXPENDITURE MANAGEMENT

32. The Checklists below can be used to measure the performance of public environmental expenditure programs against good practices. Each of the three Checklists contains five major principles, which are operationally described in the right column of the checklist. Performance auditors can assign the three following scores to each principle: “zero”, if no good practices are applied, “one”, if some but not all good practices are applied, and “two” if all good practices are applied. The scope of application of good practices is assessed by assigning a “yes”, “no” or “partially-applied” judgement. In this way, any particular program or its implementing agency can achieve a maximum of ten (10) points in each performance dimension. In order to visualise the results of performance assessment, a performance triangle is constructed by plotting the score in each dimension on the three axes of the radar chart as in Figure 2 at the end of this Chapter.

Checklist 1. Performance in Terms of Environmental Effectiveness

Principle	Good Practices
1. Additionality and consistency with other environmental policy instruments	<ul style="list-style-type: none"> Public funds do not permanently substitute for weak environmental policies; they are not spent on achieving environmental objectives that could have been achieved with administrative or economic instruments or by eliminating environmentally-harmful subsidies. Public funds are not used for environmental projects that would have been implemented anyway (e.g. that have high risk-adjusted financial rates of return and could have been financed privately). Public environmental expenditures reinforce other policy instruments and are consistent with their stated objectives. Regular running costs of environmental administration and enforcement agencies are financed through the regular budget process. Extra-budgetary or specialised expenditure programs are normally focused on financing investment in fixed assets or precisely defined non-investment projects, which are not regular duties of administration. Financial assistance to running costs of non government entities is given only in exceptional circumstances, for a strictly limited period, during which the rate of assistance declines. External auditors periodically review the environmental value-added of public expenditures; there are provisions to phase out public funds after they have fulfilled their role.
2. Sound and well-defined programming framework	<ul style="list-style-type: none"> Public funds are spent in the framework of a written, publicly available expenditure program document approved by appropriate authorities. Expenditure program has specific, measurable, agreed, realistic, time-bound objectives, eligible beneficiaries, specified financing needs, eligible project types and a set of written rules that guide the financing decisions that enable the objectives to be achieved at the least cost. Expenditure program is established as part of a wider environmental program or policy, which is a stated priority and has been developed through a participatory political process Environmental expenditure programs support sustainable development; wider economic, social and poverty reduction objectives as appropriate are integrated into the public environmental expenditure program without undermining its environmental effectiveness.
3. Sound	<ul style="list-style-type: none"> Standard application forms are used to solicit quantitative and qualitative information on

consideration of environmental effects	projects' environmental effects. Once obtained, the accuracy and reliability of this information is verified.
	<ul style="list-style-type: none"> • Indicators of environmental effects are unambiguous and are used as essential criteria in project appraisal and selection. • Environmental effects are monitored throughout the project cycle and after implementation; project level environmental data are stored in publicly available database that allows unambiguous ex-post verification and analysis. • If the project fails to achieve its predicted effects, as stated in the application form or financing contract, effective contractual sanctions on beneficiaries are enforced in proportion to the violation. • Meaningfully aggregated information on environmental effects achieved is periodically reported to governing bodies and to the public, reviewed by external auditors and used as performance indicator.
4. Maximising environmental effect from available funds	<ul style="list-style-type: none"> • Quantitative information on project full lifetime costs (investment, operational and maintenance) is requested from applicants in a standard application form and verified; project level cost data are tracked and stored in a database format in a way that allows unambiguous ex-post verification and analysis. • Project selection criteria ensure that limited public funds achieve the greatest environmental effect. An unambiguous cost-effectiveness indicator (unit lifetime cost of achieving environmental effects) and the rate of assistance from public funds form a core of quantitative basis for appraisal, scoring, ranking and selecting of projects. • Quantitative information on cost-effectiveness is periodically reported to governing bodies and to the public and is subject to periodic external, independent reviews. Cost effectiveness is a key performance indicator.
5. Leveraging additional private and foreign finance for the environment	<ul style="list-style-type: none"> • Public funds cover less than 100% of project costs; co-financing by other sources or by beneficiary retained earnings is required as a principle. • Leverage of private and foreign finance is a formal requirement and a performance indicator. • Public funds do not distort competition in financial markets and do not obstruct the development of private financial institutions. Financial products used in environmental expenditure programs do not compete with financial products offered by private financial institutions. • Full financial plan of the project is required; commitments for financing from other sources are verified. No disbursement is made until full financing for the project is adequately secured.

Checklist 2. Performance in Terms of Fiscal Prudence

Principle	Good Practices
1. Fiscal integrity of revenue	<ul style="list-style-type: none"> • All sources of revenue are clearly specified in the legislation. • If the revenues managed within the program 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. As such, this money is subject to the usual fiscal discipline in the entire public finance sector, even if it is managed outside of the budget. • Revenues are recorded at treasury accounts before they are allocated to the environmental expenditure program. • Only cash revenues are accepted.
2. Negative efficiency impacts of earmarking are minimised	<ul style="list-style-type: none"> • Earmarked revenues are limited to specified periods of time. Effective provisions are in place to prevent the creation of vested interest groups and perpetuation of public expenditure programs longer than they provide value added. • Earmarking within earmarked schemes (e.g. sub-funds within earmarked environmental funds) is avoided as it further infringes on efficiency; If it is unavoidable (e.g. for political reasons), safeguards that prevent inefficient resource allocation and perverse incentives are implemented.
3. High standards of fiscal discipline and transparency	<ul style="list-style-type: none"> • Implementation of environmental expenditure programs does not cause unplanned fiscal deficits. In particular, contingent and implicit liabilities (such as loan guarantees) are not incurred without an explicit, prior approval from fiscal authorities. Medium-term financial forecasts, including contingent and implicit liabilities of all implementing agencies, are regularly prepared and disclosed in financial statements. • For all extra-budgetary funds and government-controlled agencies, an estimate of the revenue and the corresponding expenditures is provided in the state (or sub-national) budget, at least as an annex. Statements on debt and contingent liabilities, especially of all extra-budgetary environmental institutions are presented along with the budget of the Ministry of Environment to the Ministry of Finance. • Mandatory internal and external independent financial audits are regularly carried out. • Ex-post reporting, according to a transparent expenditure classification system, is regularly conducted and publicly disclosed.
4. Accountability and transparency	<ul style="list-style-type: none"> • All individuals involved in managing expenditure programs are held accountable for decisions to the Government, Parliament and the public within their clear and distinct lines of responsibility, on the basis of effective legal provisions ensuring transparency and meaningful information disclosure. • Public funds are guarded against corruption and fraud, e.g. through effective checks and balances on various interest groups in governing bodies. Any potential conflicts of interest are eliminated. • Ex-post reports on performance and results achieved (in terms of specified performance criteria) are periodically conducted and disclosed to the public.
5. Collection of revenues and public procurement separated from expenditure management	<ul style="list-style-type: none"> • Special agencies implementing environmental expenditure programs focus on program and project cycle management and project financing, rather than on collecting revenue or making direct procurement of equipment and construction services on behalf of the government. These other tasks are performed by regular government agencies. • Collection of revenue from fiscal or quasi-fiscal instruments is normally done by relevant fiscal authorities under the control of treasury services. • National or international public procurement rules apply for all purchases that are co-financed by public funds, even if the purchasing agent is a private entity.

Checklist 3. Performance in Terms of Management Efficiency

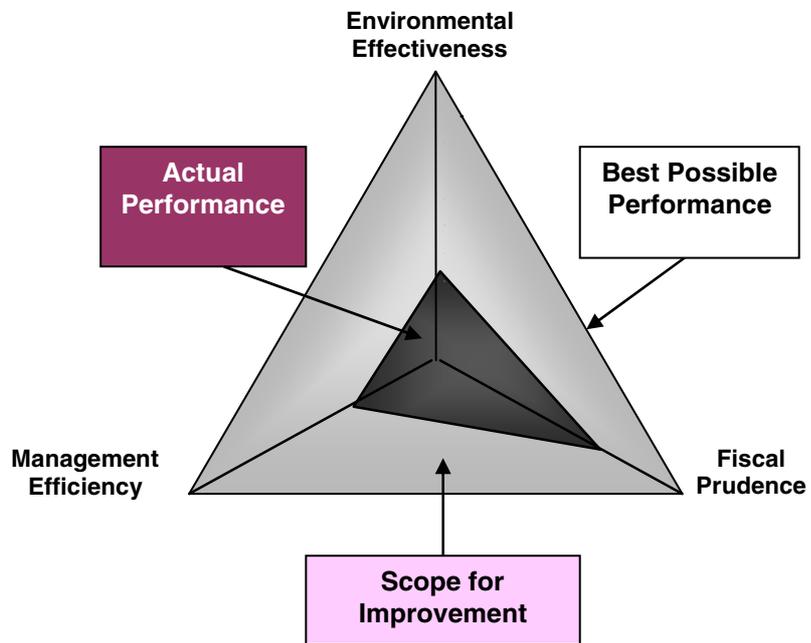
Principle	Good Practices
1. Sound governance	<ul style="list-style-type: none"> • Expenditure program is governed by clear, written and agreed rules rather than ad-hoc discretion. • Terms and conditions of financing, decision-making and administrative procedures, internal policies and principles of project appraisal and selection are written and available to the public. They are coherent and consistent, do not change frequently and randomly, although are periodically reviewed in order to identify areas for improvement. • Governing bodies of environmental expenditure programs represent the key stakeholders with appropriate checks and balances between different interest groups; non-environmental authorities, parliament and non-government organizations are duly represented. • Governing bodies are responsible for programming, priority-setting, establishing rules, performance evaluation, supervision and control. The political process is confined to programming and supervision. Political interference in the selection of specific projects for financing and beneficiaries is restricted and governed by rigid procedures.
2. Professional executive management	<ul style="list-style-type: none"> • Responsibilities for the day-to-day management and implementation of environmental expenditure program is clearly separated from responsibilities of governance bodies and clearly defined in statutory and operational documents. • Implementing agency has a written mandate on the basis of the contract or the law. Implementing agency is a professional executive management body with a fair degree of operational autonomy, but is subject to strict accountability for performance. Its responsibilities focus on project cycle management, and in particular, on impartial project appraisal and selection. • Executive managers are held accountable for performance and not judged by political affiliations. Performance indicators, established by governing bodies are clearly written and used in regular performance management. International quality management systems (such as the ISO 9000 family) are considered as a performance benchmark of the executive management. • Implementing agencies of large specialised environmental expenditure programs have staff assigned exclusively to their management and selected by executive managers. • The skills of the staff adequately match the technical requirements of a given expenditure program. The recruitment and remuneration of managers and of staff are based strictly on merits. They are adequate to attract and maintain highly qualified people and to reward integrity and commitment.
3. Sound project cycle management	<ul style="list-style-type: none"> • The project cycle is subject to intelligible, transparent and written procedures which are consistent and publicly available, in particularly to all potential beneficiaries; project cycle manual is binding to the staff and used in practice. • Project identification is proactive and follows from the environmental expenditure program established by the governing bodies and from realistic analysis of market trends and of demand for financing in the environmental sector. • Applications for financing are accepted only in standard forms tailored to different project types and supported by clear, user-friendly instructions. Application forms are easily available to all potential applicants, preferably in an electronic version. • Project appraisal and selection criteria and procedures are objective, transparent and unambiguous. Discretionary, subjective elements of project appraisal and selection are subject to explicit, written procedures. Their records are kept in publicly available files. • Appraisal systems and procedures are tailored to the size and complexity of different project types. For large investment projects, a two-stage appraisal process is used (first stage - screening against eligibility criteria; second stage - ranking of eligible projects). • The appraisal system is relatively simple, based on impersonal rules as appropriate, and allows meaningful comparison of comparable projects against each other or against a benchmark. The appraisal system also allows for an ex-post verification of the selection process, including tracking personal responsibilities for important judgements and decisions. Appraisal reports are

	clear, unambiguous and publicly available.
4. Fair and unbiased relations with external stakeholders	<ul style="list-style-type: none"> • Relations with external stakeholders (beneficiaries, intermediaries, consultants) are handled in a transparent, fully unbiased, and arms-length manner. Communication policy ensures that all applicants have equal access to information on funding opportunities and equal opportunity to have their projects impartially reviewed on a merit basis. • Outsourcing of certain tasks in project cycle management is meaningfully applied through a competitive process without perverse incentives; conflicts of interest are prevented (e.g. the same consultants cannot both prepare projects and appraise them).
5. Effective management of financial products and related risks	<ul style="list-style-type: none"> • Only financial products allowed in the statute and approved by the governance body are used by the implementing agency. • Complexity of operations and the choice of financial products are proportional to the institutional capacity to manage the associated risks. Typically, grants are the first choice, as the most transparent and market-friendly form of subsidy. • Grants are designed and disbursed in the manner that maximises incentives for timely and cost-effective implementation of individual projects and of the entire portfolio of the implementing agency. Grants are designed so as to minimise chances of misuse of public money by applicants. • As in-house capacity to manage financial risk increases, other financial products are considered in order of increasing risk, e.g. interest subsidies, loans through intermediaries, direct loans, leasing, equity investments and loan guarantees. Before a new financial product is applied, its feasibility is checked through an assessment of risks, market needs and supported by a financial plan.

33. Assessment in each dimension forms a *performance triangle*, which is constructed by assigning scores to the checklists presented above. A high score in all dimensions indicates a program or implementing agency, which performs well in terms of expenditure management. A lower score in any dimension implies a need for targeted institutional reform and strengthening or even closing down the expenditure program. The three-dimension radar chart in Figure 2 below illustrates the results of such a performance assessment³. It is worth noting that this framework does not include the full evaluation of the performance of the revenue side of an environmental financing program. This follows from the fact that the focus of these good practices is on expenditure management only. In a more comprehensive performance audit of a particular financing institution or program, the radar chart should be expanded to include one more dimension reflecting the assessment of the revenue side of the program.

³ The figure shows an actual example of the results of the performance of the National Environmental Fund of the Republic of Moldova conducted in 2002. The specific areas for improvement have been endorsed by the Moldovan Government and are now a target of an institutional strengthening project undertaken by the Ministry of Ecology, Construction and Territorial Development with international support. In the future, it will be possible to conduct another (self) assessment and to measure progress along all three dimensions.

Figure 2. Performance Triangle of Public Environmental Expenditure Programs and Management Agencies



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