UNITED NATIONS **NATIONS UNIES**

CHAIRMAN'S SUMMARY OF THE FIFTH EXPERT GROUP MEETING ON FINANCE FOR SUSTAINABLE DEVELOPMENT

FINANCE FOR SUSTAINABLE DEVELOPMENT:
TESTING NEW POLICY APPROACHES

Nairobi, Kenya, 1 - 4 December 1999
Sponsored by the Governments of the Netherlands, Ireland, and Kenya
Organised by the United Nations Department of Economic and Social Affairs (UN/DESA)
Hosted by the United Nations Environment Programme (UNEP)

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I. OVERVIEW

1. The Fifth Expert Group Meeting on Finance for Sustainable Development was held at the United Nations Office in Nairobi, Kenya, on 1-4 December 1999. The Meeting was sponsored by the Governments of The Netherlands, Ireland, and Kenya, organised by the United Nations Department of Economic and Social Affairs (UN/DESA) and hosted by the United Nations Environment Program (UNEP).

2. The main goals of the meeting in Nairobi were:

- to generate analysis and policy options that can assist the Commission on Sustainable Development (CSD) in preparing for its discussion of financial issues of Agenda 21 at its eighth session in 2000;
- to identify trends in finance for sustainable development since the 1997 Earth Summit + 5;
- to discuss a number of financial issues of sustainable development that are particularly critical for countries in Sub-Saharan Africa;
- to continue the discussion of a strategy for increasing official development assistance (ODA) and dealing with the issue of external debt;
- to further develop policy options for promoting the mobilisation of private foreign and domestic capital for investment in sustainable development;
- to discuss the possibilities of subsidy reform in the framework of a broad policy package;
- to assess the potential and actual contribution of environmental taxes and charges to the financing of sustainable development; and
- to provide an overview of how innovative financial mechanisms are applied in major economic sectors of developed and developing countries.

3. Over fifty international experts on finance and development from both developed and developing countries attended the Meeting. These experts included representatives from the private and public sectors, universities, non-governmental organisations (NGOs), government ministries, and international institutions. The participants expressed their personal opinions as experts, and not necessarily the viewpoints of the organisations with which they are affiliated. Dr. Lin See-Yan, former Deputy Governor of Bank Negara Malaysia, now a private banker, served as chairman of the Meeting. Carl Greenidge, Deputy Secretary-General of the African, Caribbean and Pacific Group of States Secretariat, served as Deputy Chairman. The Agenda of the Meeting and a list of participants can be found in Annexes I and II.

4. The Meeting recalled that sustainable development is characterised not only by economic growth in terms of GDP per capita, but also by environmental protection and improved social conditions such as poverty reduction, increased literacy and life expectancy. While there may be trade-offs among these economic, social and environmental dimensions of sustainable development, policies that address them simultaneously were the focus of the meeting.

5. Achieving the goals of sustainable development requires both international and domestic commitments. Any assessment of progress towards these goals needs to include a review of bilateral and multilateral aid effectiveness, the impact of private investment, and the effectiveness of domestic public investment policies. While the meeting strongly endorsed the urgent need for arriving at a rising trend of ODA, it recognised that this by itself would not be sufficient to reach the goals of sustainable development in developing countries. Attention must also be paid to improving the effectiveness of ODA, the responsiveness of private investment to sustainability

concerns, and the effectiveness of domestic investment and regulatory policy. In the context of Sub-Saharan Africa, the low level of private savings and investment, including foreign direct investment (FDI), is a particular cause for concern.

6. This Summary is not intended to reflect all the views and suggestions made at the meeting, nor does it represent a negotiated text. Rather, its aim is to provide a comprehensive summary of the themes of the discussions. The Summary is organised as follows: section 2 reviews recent trends in sustainable development finance; section 3 focuses on the integration of environmental finance into mainstream public finance; section 4 analyses new policy approaches in international finance; section 5 reviews new policy approaches in domestic finance; and section 6 gives an overview of innovative mechanisms for sector finance. The final section contains some proposals for future work on finance for sustainable development.

II. RECENT TRENDS IN FINANCE FOR SUSTAINABLE DEVELOPMENT

7. While the 1997 Fourth Expert Group Meeting in Santiago (Chile) had reviewed trends in development finance since the United Nations Conference on Environment and Development (UNCED), this meeting reviewed and updated events since 1997, in particular the impact of the Asian financial crisis and the continuing negotiations on the implementation of the Kyoto Protocol. Particular attention was given to finance for sustainable development in Sub-Saharan Africa.

8. The Asian financial crisis that began in July 1997 dealt a significant blow to the previously high-performing economies of East and South East Asia. It also had reverberations in other regions. Many countries that faced financial contagion in 1997 have had to significantly devalue their currencies, and in some cases, accept stringent conditions from the International Monetary Fund (IMF) and World Bank in return for emergency infusions of resources to keep their economies afloat.

9. Recovery from the financial crisis in Asia and other regions represents a major challenge for sustainable development. In various countries there is a renewed interest in institutional reform, particularly in the financial sector, and an urgent need for new approaches to broader-based policies that address poverty, as well as sustainable resource use and environmental management.

10. The on-going negotiations over the Kyoto protocol and an international climate change regime have introduced a new means for sustainable development finance. The Clean Development Mechanism (CDM) allows signatories to the Kyoto protocol to meet their emissions targets under the treaty by financing cleaner development in developing countries as an alternative to making relatively expensive emissions reductions at home. While the details of the CDM remain to be negotiated there has been significant interest shown by the private sector in this mechanism. Developing countries would be compensated with financial resources and technology transfers in exchange for providing environmental services such as emissions reduction. However, the promise of CDM, which provides an opportunity to increase financial flows to developing countries for sustainable development, is yet to be realised.

11. Sustainable development in Sub-Saharan Africa remains an elusive goal, despite progress in democratic and economic reforms in several countries. The subcontinent is not well integrated into the world economy and remains poor. Poverty and unsustainable economic practices reinforce each other, and conflicts in some Sub-Saharan African countries have diverted funds

away from expenditures for sustainable development. The AIDS epidemic and tropical diseases such as malaria continue to extract both an economic and human toll.

12. However, economic growth in Sub-Saharan Africa has improved somewhat, mainly as a result of macroeconomic reforms that many countries have been pursuing throughout the 1990s. According to the World Bank, real GDP grew at an average rate of 3.8 percent in 1994 - 1997, compared with an average annual rate of about 2.0% in the 1980s and early 1990s. Unfortunately, this fragile recovery is to a large extent financed by the exploitation of natural resources, and social groups have not equally shared the gains. Continued poverty means that Sub-Saharan Africa remains a prime candidate for increased levels of ODA from bilateral and multilateral sources, but experience to date suggests that aid alone will not effectively solve Africa's problems. In addition, national governments need to continue building a political consensus for sustainable development.

III. INTEGRATION OF ENVIRONMENTAL FINANCE INTO MAINSTREAM PUBLIC FINANCE

13. The policy framework for the mobilisation of financial resources is based on the concept of sustainable development with its economic, social, and environmental dimensions. Since the bulk of financial resources for sustainable development needs to come from domestic sources, the policy framework for mobilising domestic resources is of particular importance. The main options include efforts at strengthening domestic financial markets public expenditure reforms, implementing environmental taxes, and political commitments to redirect financial resources through macroeconomic and structural reforms.

14. As domestic financial resources need to be supplemented by external flows, national policy frameworks need to facilitate the inflow of ODA, Other Official Financial Flows, FDI and net foreign portfolio investment. Furthermore, the management of external debt needs to be addressed.

15. An important issue in designing the policy framework for the mobilisation of domestic financial resources is the integration of environmental finance into mainstream public finance. Implementing the environmental component of sustainable development goals requires co-operation between various ministries, in particular the ministries of finance and environment. Many times co-operation becomes difficult because of conflicts of interest between these ministries. Therefore, there is an urgent need to develop guidelines that can alleviate short-term conflicts and mainstream the financing of the various components of sustainable development, in particular environmental expenditures.

16. It is generally accepted that public finance should be designed to achieve allocative efficiency. This requires that all funds collected by the government from taxation and transfers (including environmental taxes and transfers) should be consolidated and then disbursed to specified activities so that the marginal benefit from all activities is equalised. Allocative efficiency is most likely when government revenue allocation is determined in an atmosphere of transparency and accountability.

17 . Moreover, allocative efficiency is achieved if no funds collected from a particular source are specifically earmarked, i.e. funds can only be spent on a designated activity. In practice, however, there is evidence that citizens are more in favour of financing increases in environmental investments when earmarking is used. When governments face tight budget constraints because of external obligations or a small tax base, earmarking may be an acceptable

last resort method of financing the environmental dimension of sustainable development. Accepting this pragmatic approach may alleviate the tensions between traditional public finance responsibilities and responsibilities for environmental investment. Therefore, the following policy options could be considered:

- Since earmarking is only a second best solution, attempts should always be made to finance environmental investment from general revenues.
- When earmarking is necessary to finance environmental expenditures, it should be explicitly acknowledged that this method of financing is expected to be temporary.
- Ministries should be required to disclose all earmarked funds in their control and the specific uses of these funds. This tends to make officials more accountable for the effective use of earmarked revenues.
- Measures that mitigate possible inefficiencies of earmarking should be taken. For example, cost-benefit analysis should be used to identify investment priorities. Furthermore, strict expenditure control, accountability and transparency should be achieved.
- Developing countries should receive additional assistance for increasing their capacity to carry out effective cost-benefit analysis of projects.

IV. NEW POLICY APPROACHES IN INTERNATIONAL FINANCE

18. As noted at the 1997 Fourth Expert Group Meeting in Santiago, the structure of external financial flows to developing countries in the 1990s is vastly different from that of previous decades. The role of private financial flows in the financing of sustainable development has increased significantly, while the share of ODA has decreased.

19. In general, new policy approaches to international finance, both public and private, must take into account the impact of globalisation on public and private flows to developing countries. They must also take into consideration the heightened interest in large scale debt relief as a result of the Enhanced Heavily Indebted Poor Countries (HIPCs) Debt Initiative agreed upon at the 1999 meeting of the G-7 countries in Cologne. An assessment of the effects of globalisation also needs to take into account the implications of the Asian financial crisis for sustainable development.

20. With regard to external public flows of resources, key considerations include the need for arriving at an increasing trend of ODA as a percentage of GNP, and the need for improving the effectiveness of ODA in achieving sustainable development goals. This is particularly important in Sub-Saharan Africa, the poorest developing region and the region that receives relatively little private capital. As for private capital flows, the implications of the narrow range of recipient countries of these resources for aid policy must be considered. In addition, an assessment of the potential of private resources to advance sustainable development needs to be undertaken.

21. Finally, given the importance of debt relief for HIPC countries, a review of policies to improve finance for sustainable development must consider whether the promotion of sustainability provides an additional rationale for debt relief, and to what extent sustainable development goals will be furthered if more substantial debt relief becomes a reality.

A. Official Development Assistance (ODA)

1. Defining a new policy agenda

22. It was noted that the Earth Summit + 5 in 1997 had called for working out strategies that would increase donor support for aid programmes and revitalise the commitments that donors made at UNCED in 1992. At the Fourth Expert Group Meeting in Santiago, three elements of a new aid strategy were emphasised. First, both donors and recipients need to reassert the primacy of the sustainable development goals of aid over short-term commercial and political motivations. Second, aid recipients need to maintain progress towards implementing sound economic, social and environmental policies. And third, donors and aid recipients need to improve aid co-ordination to reduce the risk of programme duplication and programmes working at cross-purposes.

23. It was agreed that since UNCED + 5 three developments had a major impact on the aid debate: the international financial crisis in 1997-98, the increasing concerns related to globalisation, and the growing awareness of the importance of international public goods such as the global environment and international peace. While developing countries are recovering from the 1997-98 financial crisis, their growth prospects for the foreseeable future are lower than the levels achieved in the pre-crisis 1990s. Little is left of the euphoria that characterised the first half of the 1990s when private flows to emerging markets soared. Furthermore, the benefits of globalisation in terms of employment and wealth creation have disproportionately been reaped by developed countries, so that the GDP per capita gap between the rich and poor countries has further increased. In addition, income inequality has risen in a number of developing countries. Finally, in the second half of the 1990's the preservation of international public goods has been increasingly considered by donors in their aid policies.

24. As a result of these developments since UNCED +5, a number of policy changes have become necessary. For example, in view of the current unsatisfactory trend of ODA, donor countries that do not yet meet the 0.7 percent of GNP Rio commitment should do so as soon as possible.

25. In addition, in view of the rising wealth inequality between developed and developing countries and within some developing countries, development strategies and aid policies must begin to focus on inequality in addition to the current focus on the reduction of absolute poverty.

26. Furthermore, in view of the Asian financial crisis and other relevant experience with aid conditionality, it is now generally agreed that conditionality that is unilaterally imposed by donors does not promote lasting reform. It was emphasised that the spirit and process by which economic policies are identified and agreed upon between donor and aid recipients is very important, and that the goal should be consensual policies that are based on mutual commitment to bring about policy improvements that are needed to make aid work.

27. Finally, in order to better use ODA to facilitate the integration of developing countries into the process of globalisation, it is useful to differentiate between various types of developing countries and address their particular concerns. At one extreme are the middle-income countries that have become largely integrated into the world economy (emerging market economies). At the other extreme are the poorest countries that have become increasingly marginalised. And somewhere in between are the developing countries that face both forces of integration and marginalisation (countries that are prone to bouts of integration and exclusion).

28. Emerging market economies, particularly those in Asia and some Latin American countries, receive the vast majority of FDI and foreign portfolio investment. ODA is less important to these countries for poverty alleviation and environmental protection, but support from international financial institutions is necessary to help these countries improve the institutional infrastructure of their financial sector~~s~~. The poorest countries, in particular in Sub-Saharan Africa, are most in need of continued and increased ODA. In these countries poverty remains the paramount concern. ODA should be more focused on these countries and should be carefully targeted for maximum effectiveness. For developing countries that are prone to bouts of integration and exclusion, aid should be focused on reducing poverty and inequality and target, for example, the promotion of small businesses.

2. ODA and sustainable development in Sub-Saharan Africa

29. Sub-Saharan Africa remains the region most dependent on ODA relative to FDI and other flows of private capital. Nonetheless, ODA flows to Sub-Saharan Africa have declined over the past two decades. According to the latest OECD data, net aid flows from all sources, i.e. flows from Development Assistance Committee (DAC) governments and multilateral agencies, to Sub-Saharan African countries were $19.6 billion in 1993, $18.1 billion in 1995 and $16.4 billion in 1997. As a share of total aid disbursed, Sub-Saharan Africa's portion remained approximately constant in the 1990's, at around 30%.

30. There are few indications that the level of ODA will significantly increase in the near term. It is thus all the more important for developing countries in Sub-Saharan Africa to concentrate on improving the effectiveness of aid. Aid works best in an atmosphere of political and macroeconomic stability and its effectiveness should be assessed using the criteria of sustainability. Aid co-ordination and management could be improved in various ways:

- At the national level, African governments could increase their co-operation with aid distribution agencies. In addition, checks and balances are needed to co-ordinate the demands of bilateral and multilateral donors, to deter corruption, and to ensure that aid meets stated sustainability goals.
- African countries need to ensure effective use of ODA; administrative, political, and economic bottlenecks to full disbursement must be identified and removed. Donors also need to ensure that conditionalities that tend to impede effective utilisation of ODA are removed. Governments should direct more of the ODA they receive towards promoting the small business sector.
- The role of regional institutions should be strengthened. In Sub-Saharan Africa, many environmental issues such as deforestation and desertification are transnational in nature and cannot be adequately addressed by any individual government. Therefore regional development banks could play an effective role, subject to their charters and defined objectives.
- Aid projects should be chosen on the basis of their potential for capacity building and their ability to further sustainability goals.

B. Debt

31. It was recalled that the Earth Summit + 5 in 1997 had welcomed the Debt Initiative for the Heavily Indebted Poor Countries (HIPC) as an important development to resolve the multilateral debt problem. In addition, the Expert Group had concluded at its Fourth Meeting in Santiago that effective and flexible implementation of the Initiative promises to reduce debt as an impediment to sustainable development in participating countries. After three years of experience with the

HIPC Debt Initiative, it was felt that while the Initiative was an improvement over previous rescheduling exercises, its process was too slow and the debt relief provided was not adequate to achieve debt sustainability, in particular for countries that export primary commodities with volatile prices. Therefore, the Enhanced HIPC Debt Initiative proposed at the G-7 Cologne Summit should be particularly welcomed since it not only aims at bringing about sustainable debt levels but also assists in promoting poverty reduction.

32. The magnitude of the debt burden of HIPC countries, most of which are in Sub-Saharan Africa, has been well documented. Recognising that the debt-export ratio of these countries is unsustainable and that there is little realistic possibility of existing debt ever being paid off, countries committed to reform will be eligible to receive significant debt relief. In Sub-Saharan Africa, some countries have already qualified for the Enhanced HIPC Debt Initiative.

33. To the extent that under the Enhanced HIPC Debt Initiative additional resources are made available and used for social investments, the prospects for sustainable development will improve. However, little additional revenue for public expenditure may in fact become available as a result of the Enhanced HIPC Debt Initiative if debt relief is financed from funds that were earmarked for ODA or if the debt that is cancelled had little prospects of being serviced anyhow. Moreover, debt relief cannot resolve the problem that HIPC countries will remain vulnerable to commodity price volatility and declining terms of trade.

C. Foreign Direct Investment and Foreign Portfolio Investment

34. Foreign direct investment (FDI) and foreign portfolio investment (FPI) are increasingly important sources of external finance for developing countries. According to the OECD, private flows to developing countries totalled $53 billion in 1991 and $292 billion in 1996. These private flows are concentrated in several important emerging economies such as China. FDI in Sub-Saharan Africa is directed primarily towards resource-rich economies.

35. The volume of FDI and FPI needs not only to increase but also be made more supportive of sustainable development goals. Furthermore, in particular the volatility of FPI needs to be reduced.

36. A critical concern is the increase of private capital flows to Sub-Saharan Africa, both by enhancing the attractiveness of national economies and the access of investors to regional financial markets. There is also a need for capital exporting developed countries to create conditions that will encourage the flow of private capital to Sub-Saharan Africa.

1. Increasing the contribution of FDI and foreign portfolio investment to sustainable development

37. Environmental FDI, such as investments in cleaner production technologies, is generally not considered attractive by foreign investors. Furthermore, their preference for resource extractive investments tends to compromise sustainable development goals, even though these investments have brought much needed capital to poor countries.

38. The Fourth Expert Group Meeting in Santiago noted that most FDI does not gravitate towards countries with lower environmental standards or lax enforcement. Recent research has brought further empirical evidence to support this conclusion. Nevertheless, increased efforts should be made to monitor the environmental performance of foreign investors in different sectors, in particular the resource-using sector.

39. To insure that FDI helps raise the average environmental performance in recipient countries, host countries may consider entering into benchmarking agreements with foreign companies in which they commit themselves to maintaining the highest social and environmental standards and reporting regularly on their performance.

40. In referring to recent work undertaken by the OECD, recommendations were made to improve policy and institutional frameworks for further integrating FDI and environmental policy goals. This would also require the strengthening of co-operation between different ministries and between government, industry and NGOs.

41. There was general agreement that more research needs to be undertaken to formulate policies for the promotion of FPI and assess its impact on sustainable development. It was pointed out that FPI could promote sustainable development in various ways because it is fungible, flows mainly to domestic firms and helps strengthen the process of domestic capital market development. However, at the same time FPI can also lead to disruptions of sustainable development because it tends to be even more volatile than FDI.

2. Attracting increased flows of private foreign capital to Sub-Saharan Africa

42. It can be expected that private capital flows into developing countries, especially to emerging markets, will continue to grow rapidly into the foreseeable future. The challenge is to attract more foreign investment into the poorer countries, and direct it to sustainable development activities. Of particular concern is foreign private investment in Sub-Saharan Africa.

43. Private investment rates in Sub-Saharan Africa are much lower than in other developing regions. This suggests that the returns to investment in the region are not sufficiently high to compensate private investors for real or perceived risks. In other words, in risk-adjusted terms, returns to investment tend to be inadequate. A policy package that reduces the risk factors to foreign investment should include the following elements:

- A strong commitment to needed macroeconomic reform along with political stability.
- Strengthened domestic institutions, including the central bank and the judiciary.
- Legal recourse in the event of default or non-performance, greater sophistication of statutes and enhanced legal capacity for dispute resolution.
- Regional market integration and regional harmonisation of standards and practices.
- Regionalisation of capital markets to increase liquidity and provide access to venture capital for domestic investors, particularly smaller businesses. This will require, for example, an upgrading of national financial infrastructures and greater reliability and comparability of national financial data.
- Deployment of ODA to enhance the financial infrastructure of countries.
- Incentives and voluntary agreements that enhance corporate governance to ensure that FDI does not compromise long term sustainable development goals.

V. NEW POLICY APPROACHES IN DOMESTIC FINANCE

A. Subsidies

44. It was reiterated that there is still a need for both developed and developing countries to reduce or eliminate subsidies that conflict with sustainable development goals because they encourage over-use of inputs and tend to reduce social welfare. Examples of such subsidies include price supports for final goods and subsidisation of key inputs.

45. It was agreed that the removal of subsidies is extremely difficult politically. In effect, the subsidies create economic rents, which become an economic asset for their recipients. Moreover, the competition for these rents can promote corruption.

46. Subsidy reform is complex and unlikely to succeed without a gradualist approach that is pursued in the framework of wider political, economic and social reforms. A policy package aimed at subsidy reduction should therefore include the following elements:

- To deal with the political dimension of subsidy reform, public awareness campaigns concerning the nature and scale of prevailing subsidies should be initiated. For example, the transparency of subsidy policies should be increased by registration of special interest donations to political campaign funds, and the influence of special interest groups should be curtailed by limiting the size of such donations. Furthermore, to build political will for subsidy reduction and increased transparency, annual national reports that identify major subsidies and provide estimates of their costs should be prepared and published. Based on these reports, an international reporting system should be established to assess the worldwide economic, environmental and social impacts of subsidies.
- In regard to the economic dimension of subsidy reform, there is a need to measure the efficiency of subsidies in reaching their stated goals and a need for phasing out subsidies gradually, according to a pre-announced time schedule. Furthermore, efforts should be made to determine who is bearing the cost of subsidies. The contribution of privatisation to subsidy reduction appears to be ambiguous. Privatisation tends to reduce subsidisation because it exposes firms to market forces, but it may also create unintended rents for the private sector.
- With regard to the social dimension of subsidy reform, it is necessary to acknowledge that one of the main goals of subsidies, the protection of the poor, in many cases is not achieved in practice. Examples include the subsidisation of water, agricultural inputs and housing. Subsidy reforms need to be accompanied by measures that address their social implications for the poor. In some cases, temporary compensation of those who lose from reform could be considered.

47. Unfortunately, experience with testing this “package approach” is still too limited to draw general conclusions. In particular, more work must be done to determine how governments can ensure that explicit subsidies are not simply replaced with hidden subsidies. Furthermore, more guidance needs to be given to governments with respect to environmental subsidy policies. For example, it has been shown that subsidies for pollution abatement tend to make the polluting industry more profitable, attract more firms into the industry and therefore worsen pollution in the long run.

B. Environmental taxes and charges

48. There is an increasing amount of experience with environmental taxes and charges, in particular in developed countries. This experience confirms that these instruments can improve

cost-effectiveness relative to conventional regulations as well as bring positive environmental effects. Tax fraud with environmental taxes is more difficult than with income taxes; this provides an additional benefit to the use of environmental taxes. A major barrier to the use of environmental taxes and charges in developing countries is the lack of institution building. Furthermore, there are complex tax design requirements and the mainstream public finance agencies have limited experience in dealing with the introduction of such taxes.

49. In developed countries, environmental tax reform has accelerated in European Union (EU) member countries. These countries are embarking on broad-based environmental tax reform in which distortionary taxes on labour are being gradually replaced with environmental taxes in a revenue-neutral fashion. These countries have found that the barriers to the implementation of such taxes, particularly energy taxes, can be mitigated through careful tax design. The most important of these barriers is political opposition resulting from concerns over the negative effects of pollution taxes on international competitiveness. This is commonly referred to as the "pollution haven" hypothesis, which is not supported by empirical evidence. In any event, international co-ordination may lessen any such effect.

50. There are also concerns that energy taxes will result in a loss of jobs in energy-intensive sectors. This has been addressed by the use of differentiated tax rates on transport, industry, households, and the gradual implementation of the new taxes. Environmental taxes are also indexed to inflation to ensure that they remain effective.

51. The experience in the EU suggests that developed countries may benefit from the increased use of environmental taxes and charges, provided that they are carefully designed. Furthermore, environmental taxes can help to integrate environmental dimensions into traditional fiscal policy.

52. Developed countries should be encouraged to further promote green budget reform by charging for environmental services and infrastructure and internalising costs through environmental taxes. Moreover, green budget reform commissions involving major stakeholders could help to overcome political barriers to environmental taxes.

C. Private Sector participation

53. While the issue of private sector participation in the financing of sustainable development has featured prominently in the work of the CSD and the Expert Group in the UNCED follow-up, there is still a lack of a unifying analytical framework that brings together the wide range of experiences in both developed and developing countries. Moreover, the largely anecdotal success stories of private sector participation tend to focus on the environmental dimension of sustainability and neglect the important social aspects of sustainability.

54. In analysing recent trends in private sector participation, the Meeting focussed on the impact of private sector investment on the local environment and in this context addressed also the impact of privatisation. Participants expressed particular concern over the impact of the strong growth of private transportation and the increased exploitation of natural resources on the local environment. Furthermore, participants emphasised the importance of privatisation as a source of finance for sustainable development. There was also some discussion on the role of the private sector in the financing of global environment protection, and participants felt that in the next decade the private sector can be expected to play a much greater role than in the past once the mechanisms of the Kyoto protocol will be fully implemented.

55. The policy discussion identified major weaknesses in the promotion of private sector participation in the financing of sustainable development. As far as the enforcement of environmental regulations is concerned, it was emphasised that the whole system of regulations, monitoring and compliance requires capacity-building and greater involvement of civil society.

56. As to the role of privatisation, the important role of the regulatory framework for achieving a positive impact on sustainable development was emphasised. Moreover, it was felt that there is a need to further analyse why a number of privatisations had a negative impact on sustainable development.

57. In the area of private sector portfolio investment, there is increasing evidence that corporate environmentalism is becoming mainstream practice; pension fund managers and trustees of charitable organisations have expressed interest in financing socially responsible investments (SRIs). This interest is heightened by evidence that financial markets do reward firms for good environmental performance. The following policies for promoting socially responsible portfolio investments should be considered:

- Introducing environmental liability legislation. This creates an explicit link between environmental risk and financial risk that can be priced by the equity markets.
- Enacting regulations that promote environmental and socially responsible screening of investments. For example, the United Kingdom requires all pension funds to report on their SRI policy. Transition economies now designing pension schemes should also consider such rules.
- Developing and standardising a screening methodology for benchmarking and ranking investments according to sustainability criteria.
- Reforming fiduciary legislation to approve SRIs.
- Identifying and explicitly packaging SRIs, particularly in emerging markets.

VI. INNOVATIVE MECHANISMS IN SECTOR FINANCE

58. The past ten years have witnessed the development of innovative instruments for sector finance, especially for the infrastructure sectors such as power, water, sanitation and public transport. This is a result of (i) an increasing realisation that experience with the traditional model of public provision and financing has been disappointing in terms of quality of service, coverage and costs, and (ii) declining sources of finance as ODA stagnated and public expenditures were cut. Governments are seeking private capital at home and from abroad to meet the infrastructure-financing gap and as a means of introducing market mechanisms to improve the quality of service.

59. At the same time, financial markets have evolved in complementary directions by developing innovative financing instruments. These include public-private partnerships, new forms of credit guarantees, sub-national financing without sovereign guarantees, new micro-financing mechanisms for the informal and rural sectors and joint ventures. Some of these instruments, for example, have been of interest to institutional investors for infrastructure projects. Similarly, institutional changes in developing countries such as decentralisation and devolution of taxing power to local governments have created opportunities for sub-national governments to access the international capital market without relying on central government guarantees.

60. While these innovative financing mechanisms have accessed new, previously inaccessible sources of funds for sector investments and, in combination with a more realistic pricing of

services, have enhanced the financial sustainability of sectors such as power, water, sanitation and transport, they have not necessarily enhanced environmental sustainability. Furthermore, despite the obvious similarities among the innovative financing instruments in sector finance, there are also significant differences.

61. In the power sector, for example, the main innovations have been in terms of deregulation and the introduction of competition through independent power producers (IPPs). Deregulation has allowed energy prices to be gradually freed to reflect the full cost of supply. The energy utilities have begun to access domestic and foreign capital markets by demonstrating to investors acceptable financial practices and competitive returns. However, the new financing mechanisms for the power sector are not without problems with regard to environmental sustainability. The financial incentives to investors favour conventional thermal power, and low energy prices for consumers (as a result of competition) favour increased energy consumption.

62. Renewable energy is generally more expensive for consumers than conventional technology, in part because of fossil fuel subsidies, a failure to internalise the environmental benefits of renewables and the environmental costs of fossil fuels, low costs of fossil fuels, lack of support for research and development in the sub-sector, and untapped scale economies. Recent innovations include "percentage renewable energy requirements" for power distribution companies and green energy procurement policies. Policy reforms should promote full cost pricing of fossil fuels, incentives for R&D, and financing mechanisms tailored to the scale of renewable energy.

63. In the water sector, the major innovation of the last decade is the increased access to domestic and international capital markets through (i) build-operate-transfer (BOT) arrangements, (ii) public offerings of shares of municipal water utilities, (iii) issuance of municipal revenue bonds secured by user fees, and (iv) establishment of municipal development banks. For further development of these financial mechanisms, it is imperative that there is a stable investment environment in the sector, including: predictable fiscal relations between local and central governments; autonomous public utilities with secure income; transparent city budgets; protection of creditors' rights; and an independent regulatory body. Bundling water and sanitation services, fee amortisation and micro-financing schemes have also contributed to increased financial sustainability of the sector.

64. The transport sector has benefited from many similar financial mechanisms. BOT and related mechanisms have been used in the construction and operation of toll roads. Privatisation through public bidding has been used to improve urban transport systems, such as metro and rail services in Latin America. To ensure environmental sustainability along with financial sustainability, environmental costs must be fully internalised into the cost of private vehicle ownership and use. Public bidding process must be designed to encourage bidders to take into account the environmental costs and benefits of their potential investment. In Africa, earmarked taxes and fees have been combined with the creation of autonomous road agencies to maintain the rural road system and improve the collection of fuel taxes.

65. Sustainable forestry management, which has traditionally been difficult to finance, has received a financial boost from emerging carbon markets, the Clean Development Mechanism (CDM), bio-prospecting contracts with pharmaceutical companies, and the rapid growth of eco-tourism. Furthermore, some countries have introduced systems of payments for watershed protection and other environmental services. Despite this progress, much remains to be done to actually implement CDM, to further develop carbon markets, to fully price access to national

parks, to develop trust funds for forest protection, and to ensure that local stakeholders benefit from these innovative financing mechanisms.

VII. PROPOSALS FOR FUTURE WORK

66. It is proposed that the CSD supports research in the following areas:

(i) Research is needed to determine the relationship between foreign investment and sustainable development. This would help to identify which types of foreign investment contribute most significantly to sustainable development and to determine which policy levers should be used to increase the compatibility of foreign investment with sustainable development.
(ii) Research is also needed to investigate whether globalisation and sustainability goals provide a new and compelling rationale for debt reduction and a rising trend of ODA.
(iii) Calculations of the magnitudes and costs of unsustainable subsidies should be improved to provide additional political support for their continued reduction as well as insight into the effect of subsidy removal on the poor.
(iv) Research should be undertaken on green budget reforms.
(v) Research should be undertaken on capacity and institution building for the mobilisation of financial resources for sustainable development in order to respond better to developing countries' requests for technical assistance.
(vi) In all proposed research work the co-operation of civil society should be sought.

67. In view of the complex issues related to the mobilisation of financial resources for sustainable development, it is suggested that the CSD continue promoting expert meetings on cross-sectoral and sectoral issues with a focus on finance for sustainable development for the implementation of Agenda 21.

68. Finally, recognising that focus was put on developing countries in Asia, Latin America and Africa in previous Meetings, and to support the preparations for UNCED +10 in 2002, it is proposed to convene the **Sixth Expert Group Meeting on Finance for Sustainable Development** in 2001 and include in the agenda a number of financial issues of Agenda 21 that are of particular importance for countries in Central and Eastern Europe. OECD expressed interest in co-organising such a meeting and proposed to convene it at the Regional Environmental Centre in Budapest, Hungary.

ANNEX I

AGENDA

Rapporteur: Theodore Panayotou, Harvard Institute for International Development

Wednesday, 1 December 1999

9:00 am Registration

9:30 am Opening Session

Jorge Illueca, Assistant Executive Director, Division of Environmental Conventions, United Nations Environment Programme

The Honourable Chrisanthus Okemo, E.G.H., M.P., Minister for Finance, Government of Kenya

Ron Lander, Head, International Environmental Policy, Instruments and Water Management Division, Environment and Development Department, Ministry of Foreign Affairs, The Netherlands

Dympna Hayes, First Secretary, Permanent Mission of Ireland to the United Nations

JoAnne DiSano, Director, Division for Sustainable Development, United Nations Department of Economic and Social Affairs

Break following the Opening Session

Session I: **IMPROVING THE POLICY FRAMEWORK FOR SUSTAINABLE DEVELOPMENT FINANCE**

10:45 am Chairman's Introduction

Lin See-Yan, Chairman of the Fifth Expert Group Meeting

11:00 am *Taking stock of sustainable development finance in Sub-Saharan Africa since Rio+5"*

Author: T. Ademola Oyejide, University of Ibadan, Nigeria
Discussant: Theodore Panayotou, Harvard Institute for International Development

12:00 pm Lunch break

Session I (continued)

2:00 pm *Sustainable development finance and mainstream policy-making: principles of integrating environmental finance into public finance*

Author: Grzegorz Peszko, Organisation for Economic Co-operation and Development
Discussant: Ron Lander, Environment and Development Department, Ministry of Foreign Affairs, Government of the Netherlands

Session II: **NEW POLICY APPROACHES IN INTERNATIONAL FINANCE**

3:30 pm *Reversing the decline of ODA: How effective is the current policy agenda*?

Author: Kazuo Takahashi, International Development Research Institute, Japan
Discussant: Marco Ferroni, World Bank

5:00 pm Close

Thursday 2 December 1997

Session II (continued)

9:00 am *ODA and Sustainable Development in Africa: towards a new strategy*

Author: R. Omotayo Olaniyan, Organisation of African Unity
Discussant: Geoffrey N. Mwau, United Nations Economic Commission for Africa

10:00 am *The impact of external debt on sustainable development finance in Sub-Saharan Africa*

Author: Nguyuru H.I. Lipumba, Consultant, Tanzania
Discussant: Augustin Fosu, African Economic Research Consortium, Kenya

11:00 am *Increasing the contribution of FDI and foreign portfolio investment to sustainable development: recent domestic and international policy measures*

Authors: Peter Gray and John Dilyard, Rutgers University, USA
Discussant: Thomas Brewer, Copenhagen Business School, Denmark

12:00 pm Lunch Break

Session II (continued)

2:00 pm *Attracting increased flows of private capital to Sub-Saharan Africa: essential elements of a policy package*

Authors: Louis Kasekende and Ashok Bhundia, Bank of Uganda

The impact of regionalisation in the African capital markets sector and the mobilisation of foreign capital for sustainable development

Author: Nicholas Biekpe, University of Stellenbosch, South Africa

Discussant for the two above papers: Charles Okeahalam, University of the Witwatersrand, South Africa

Session III: **NEW POLICY APPROACHES IN DOMESTIC FINANCE**

3:30 pm *Advancing subsidy reforms: towards a visible policy package*

Authors: David Pearce with Donata Finck von Finckenstein, CSERGE, University College, London, UK
Discussant: Andre de Moor, Ministry of Economic Affairs, The Netherlands

5:00 pm Close

Friday 3 December 1999

Session III (continued)

9:00 am *Recent experiences with environmental tax reform in developed countries*

Author: Kai Schlegelmilch, Federal Ministry for the Environment, Nature Conservation and Nuclear Safety, Germany
Discussant: Grzegorz Peszko, Organisation for Economic Co-operation and Development

10:00pm *Increasing the role of environmental taxes and charges as a policy instrument developing countries: some conceptual considerations*

Author: Jhrgen Backhaus, University of Maastricht, The Netherlands
Discussant: R. Omotayo Olaniyan, Organisation of African Unity

11:00 am *Promoting private sector participation in the financing of sustainable development*

Authors: Anil Markandya with P. Francis, University of Bath, UK
Discussant: Carl Greenidge, Africa, the Caribbean and the Pacific Group States

12:00 pm Lunch Break

Session III (continued)

2:00 pm *The greening of financial markets*

Author: Carlos Joly, Storebrand Investments, Norway
Discussant: Thomas Brewer, Copenhagen Business School, Denmark

Session IV: INNOVATIVE MECHANISMS IN SECTOR FINANCE

3:00 pm *Innovative mechanisms for sector finance: differences and commonalities*

Author: Theodore Panayotou, Harvard Institute for International Development, USA

Promoting private sector financing of commercial investments in renewable energy technologies

Author: UNEP

Discussant for the two above topics: Eric Chatman, African Development Bank

5:00 pm Close

Saturday 4 December 1999

Closing Session

9:00 am Presentation and discussions of draft Chairman's Summary

12:00 pm Lunch

Closing Session (continued)

2:00 pm Discussion of draft Chairman's Summary

5:00 pm Chairman’s Closing Remarks

Background Papers and Documents:

1. UNEP’s financing services initiatives: banking and insurance
   Author: UNEP, 1999.

2. “Taking stock of trends in sustainable development financing since Rio,” in *Finance for Sustainable Development: The Road Ahead* (New York: United Nations), 1997.
   Author: Theodore Panayotou

3. Information note on the United Nations Meeting on “Finance for Development,” September 1999.

ANNEX II

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