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Division for Sustainable Development

FINANCE for SUSTAINABLE DEVELOPMENT

Testing New Policy Approaches

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PREFACE

FINANCE plays a pivotal role in implementing the environmental, social and economic policies needed to attain the objectives of Agenda 21. It is also an area that presents immense challenges. These challenges are illustrated at the international level by the international financial crisis of 1997-98 and the stagnant levels of official development assistance throughout the 1990s. At the domestic level, they are illustrated by the difficulties in removing environmentally damaging subsidies and in raising domestic financial resources, particularly in developing countries where poverty and unemployment are high, debt payments burdensome and policy options limited.

Challenges such as these must be addressed and overcome. Current policies must be continuously reviewed and improved upon and, where necessary, new policies must be tested and implemented. During this process, new policies must be debated among experts and scholars, and information about the policies and their implementation must be disseminated.

The purpose of *Finance for Sustainable Development: Testing New Policy Approaches* is to contribute to this process. It contains papers presented at the Fifth Expert Group Meeting on Finance for Sustainable Development, held in Nairobi, Kenya, 1-4 December 1999. Experts from national governments, academia, international and regional organizations, NGOs and the private sector presented and debated the papers in this volume. The overall theme of the papers is testing new policy approaches in financing sustainable development. The major areas of focus are improving the policy framework for sustainable development finance, new policy approaches in international and domestic finance, and innovative mechanisms in sector finance. There is an emphasis on Sub-Saharan Africa, with several papers addressing specific issues related to finance for sustainable development in that region.

The Chairman's Summary of the Meeting and the papers were presented to the Eighth Session of the United Nations Commission on Sustainable Development in May 2000. This publication will also serve as an input to the International Conference on Financing for Development to be held in 2002.

On behalf of the United Nations, I would like to express my gratitude to the Governments of The Netherlands, Ireland and Kenya for sponsoring the Fifth Expert Group Meeting and this publication. I also express my sincere appreciation to the United Nations Environment Programme for hosting the Meeting. Finally, I would like to thank the United Nations Office in Nairobi for supporting us in the on-site organization of the Meeting.■

Nitin Desai

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Under-Secretary-General
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Social Affairs

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Finance for Sustainable Development: Testing New Policy Approaches
Edited by *Juergen Holst, Donald Lee and Eric Olson*

The Fifth Expert Group Meeting on Finance for Sustainable Development was sponsored by the Governments of The Netherlands, Ireland and Kenya, hosted by the United Nations Environment Programme (UNEP) and organized by the United Nations Department of Economic and Social Affairs (UNDESA). The meeting was held at the United Nations Office in Nairobi (UNON) Gigiri Conference Centre from 1-4 December, 1999. Experts from national governments, academia, international and regional organizations, non-governmental organizations (NGOs) and the private sector took part as authors, discussants and participants. Contributors to the Meeting and this volume are:

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Those who took part as formal discussants at the Meeting are: *Thomas Brewer, Eric Chatman, Andre de Moor, Marco Ferroni, Augustin Fosu, Carl Greenidge, Ron Lander, Geoffrey Mwau, Charles Okeahalam, R. Omotayo Olaniyan, Theodore Panayotou and Grzegorz Peszko*. A complete list of those who participated in the Meeting is included in Annex II. The African Development Bank, the United Nations Economic Commission for Africa and the United Nations Development Programme, Kenya recommended several experts from Africa.

The UNDESA staff member in charge of the Meeting's organization was *Juergen Holst*, assisted by *Donald Lee* and *Eric Olson*. Administrative support was provided by *Surinder Punj* and *Masachika Suzuki*. Support for the on-site organization and administration of the Meeting was provided by UNEP and UNON, in particular, *Shafqat Kakakhel*, *Amadeo Buonajuti*, *Shahida Ali-Butt*, *Jessica Wanyama* from UNEP and *Alexandar Barabanov*, *Aidar Karatabanov*, *Gertrude Aguti*, *Galina Kahumbura*, *Alex Makomere*, *Nelson Kahiu*, *Peter Waweru* and *David Ojwan'g* from UNON. On-site English-French interpretation of the Meeting was performed by *J.P. Pama*, *Kebba Jarju*, *Maria-Lily Pavlidis* and *J.K. Muhindi*.

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FINANCE FOR SUSTAINABLE DEVELOPMENT: TESTING NEW POLICY APPROACHES

INTRODUCTION

Juergen Holst, Donald Lee and Eric Olson*

THE Programme for the Further Implementation of Agenda 21, agreed upon at the Earth Summit+5 in 1997, contained proposals for new policy approaches in regard to the mobilization and allocation of financial resources for sustainable development. The Fifth Expert Group Meeting on Finance for Sustainable Development (Nairobi, Kenya, 1–4 December 1999) undertook a review of the testing of these approaches in practice.

In reviewing the proposals of the Earth Summit+5, the Expert Group provides inputs to the discussion on finance for sustainable development at the World Summit on Sustainable Development which will be convened in Johannesburg, South Africa in 2002. As financial resources are a crucial element for the implementation of Agenda 21, it can be expected that the discussion of financial mechanisms will be one of the most debated issues at the forthcoming Summit. It is also hoped that the review undertaken by the Expert Group will be a useful input for the forthcoming International Conference on Financing for Development in 2002.

This volume contains the proceedings of the Fifth Expert Group Meeting on Finance for Sustainable Development[1] which was attended by experts from government, international and non-governmental organizations, academia and the private sector.

The volume starts with the introductory statements delivered during the opening session.

The introductory statements are followed by the Chairman's Summary. A draft of this Summary was discussed during the last day of the Meeting, and its final version reflects the comments and suggestions made by the experts. The Summary contains an analysis of major problems in mobilizing and allocating financial resources for sustainable development and provides key policy options for their solution. It is particularly useful for national policy makers and other readers pressed for time.

The volume then addresses the first part of the Meeting agenda, the discussion of how to improve the policy framework for sustainable development finance. T. Ademola Oyejide of the University of Ibadan, Nigeria, addresses this issue by analyzing recent developments in sustainable development finance in Sub-Saharan Africa. The author advocates a policy framework with a better balance of domestic and external resources for investment finance and discusses the potential danger of volatile external resource flows for economic growth. A more narrow but nevertheless important issue of policy design is addressed by Grzegorz Peszko of the Organisation for Economic Co-operation and Development who makes a convincing argument in favor of integrating public environmental expenditure management into general public finance. Based on the experience of economies in transition in Central and Eastern Europe, he argues that public institutions managing environmental expenditures should adhere to acknowledged standards of sound public finance and focuses in this context on autonomous public environmental funds.

The volume then turns to the second part of the Meeting agenda, which deals with new policy approaches in international finance and focuses on new strategies for official development assistance (ODA), a better design of policies for attracting private foreign capital flows and policy action for further debt relief. The contribution of Kazuo Takahashi of the International Research Institute in Japan takes a critical look at the current policy agenda for improving the unsatisfactory situation in regard to ODA and makes several proposals for policy changes. For example, he suggests to resolve the issue of ODA in the framework of a wider strategy dealing with economic

* Juergen Holst is Chief, and Donald Lee and Eric Olson are staff members, of the Finance, Industry and Trade Unit, Division for Sustainable Development, United Nations Department of Economic and Social Affairs.

[1] The proceedings of the Third and Fourth Expert Group Meetings were published as *Sustainable Development Finance: Opportunities and Obstacles* (United Nations, 1996) and *Finance for Sustainable Development: The Road Ahead*, edited by Juergen Holst, Peter Koudal and Jeffrey Vincent (United Nations, 1997), respectively.

and political globalization, develop differentiated strategies toward different categories of aid recipients and start conceptualizing a longer-term strategy for ODA in which global goods would play a central role. Takahashi's conceptual discussion of global ODA issues is complemented by proposals for a reform strategy for ODA in Africa by R. Omotayo Olaniyan of the Organization for African Unity. He emphasizes that the way forward should be a strategy that identifies ways to strengthen the political will in donor countries for higher ODA commitments, outlines measures to disburse aid more efficiently to priority areas in recipient countries, and recommends pressure on policy makers to abandon all forms of tied aid.

Nguyuru H.I. Lipumba of the Civic United Front in Tanzania argues that new strategies for ODA must be matched by strategies for dealing with the debt problem, in particular in Sub-Saharan Africa. In regard to current debt relief strategies he argues that linking debt relief to implementing conditions imposed by the International Monetary Fund and World Bank undermines the principle of policy ownership in debtor countries. Instead, he emphasizes that it will be necessary to implement across-the-board debt cancellation to facilitate poverty-reducing growth strategies in debtor countries.

In addition to dealing with the problems of ODA and debt relief, it has become increasingly important for countries to attract foreign private capital inflows for investment in sustainable development. Peter Gray of Rutgers University, USA, and John Dilyard of St Francis College, USA, focus in their article on foreign direct investment (FDI) and foreign portfolio investment (FPI), which contribute to economic growth and technology transfer, social development and environmental goals. The authors discuss the problems that developing countries may face if they rely heavily on these capital flows and address various policies aimed at strengthening the necessary institutional infrastructure for FDI and FPI. The contribution of Louis Kasekende and Ashok Bhundia of the Bank of Uganda discusses the issue of foreign capital inflows from the perspective of African countries and outlines essential elements of a policy package. The authors analyze why Sub-Saharan Africa has not been able to attract large inflows of foreign capital in the 1990s and highlight negative investor perceptions and political risks. They propose policy options that could remove the impediments to larger capital inflows and emphasize institutional reform, investment in human capital and infrastructure and ensuring macroeconomic stability. A strategy for ensuring increased inflows of capital into Sub-Saharan Africa needs also to include a greater regionalization of capital markets. Nicholas Biepke of the University of Stellenbosch in South Africa analyses the current state of regionalization and makes a number of proposals to accelerate progress towards further regionalization.

The volume then turns to the third part of the Meeting agenda, which addresses new policy approaches in domestic finance and focuses on subsidy reform, the role of environmental taxes and tradable permits as well as ways and means of promoting a greater role of the private sector in financing sustainable development. In view of the heavy burden of subsidies for public finance, subsidy reforms will continue to play a central role in the discussion of finance for sustainable development. However, as David Pearce and Donata Finck von Finckenstein of University College London, United Kingdom, point out in their article, subsidy reforms should not be pursued as isolated policy measures but as a policy package reflecting a wider program of macroeconomic and political reform. This gradualist approach has to consist of pre-announced policy measures and step-by-step subsidy reductions combined with public awareness campaigns and efforts at increasing transparency and accountability.

"Green taxes" and tradable permits for controlling pollution can make important contributions to reducing the financial requirements for sustainable development. Most countries have relied more on taxes than on tradable permits to control pollution. John Norregaard and Valérie Repellin-Hill of the International Monetary Fund conclude that even though in theory neither instrument seems to be preferable to the other, in practice most countries have relied more on taxes than on tradable permits. The authors examine in their paper a number of lessons to be learned from country experiences regarding the design and implementation of both instruments and conclude that the willingness to experiment with tradable permits seems to be growing in view of the Kyoto protocol emission targets. The overview article by Norregaard and Repellin-Hill is complemented by an in-depth evaluation of recent experiences with ecological tax reform with a focus on Europe by Kai Schlegelmilch of the Federal Ministry for the Environment, Nature Conservation and Nuclear Safety of Germany. The author concludes that these taxes have been effective and quotes as examples of particularly successful taxes those on sulfur dioxide in Denmark and Sweden, on nitrogen oxides in Sweden, on water pollution in the Netherlands, and the various tax differentiation schemes for fuels in most European countries. In view of the many obstacles that are still in the way of a more widespread use of environmental taxes worldwide, the article by J.G. Backhaus of Maastricht University, The Netherlands, on environmental taxes with its focus on various conceptual considerations makes a useful contribution to advancing the policy debate.

Much has been written on the proposition that the private sector has a major role to play in the financing of sustainable development. A. Markandya and P. Francis of the University of Bath, United Kingdom, give an overview of the debate and discuss briefly privatization and infrastructure investment as potential sources of finance. In regard to private sources of finance for global environmental protection the authors conclude that progress can be expected if the flexibility mechanisms of the Kyoto Protocol are implemented in the first decade of the millennium. As for investments related to the sustainable use of the local environment, the authors emphasize that it is difficult to make an overall appraisal of investment trends. Positive developments are the increased use of incentives for environmental protection through the use of economic instruments, the reduction of environmentally damaging subsidies and higher standards for investment appraisals. Another positive development is that some investors seek out and are overweight in eco-efficient and socially-aware enterprises. This development is analyzed and evaluated in a contribution by Carlos Joly of Storebrand ASA, Norway, on the greening of financial markets. The author reports that the United States and Europe are seeing to some extent a virtuous circle of environmental legislation, corporate environmentalism and investor preferences in favor of environmentally and socially responsible corporations.

The volume then addresses the final part of the Meeting agenda, which deals with innovative financial instruments and mechanisms in sector finance. The core paper was provided by Theodore Panayotou of the Harvard International Institute for Development, USA. The paper explores innovative financial mechanisms in energy, transportation, water, sanitation and forestry and identifies similarities and differences between these mechanisms. The paper also discusses to what extent instruments and mechanisms that are successful in one sector can be replicated in other sectors. In regard to replicating financial instruments and mechanisms the paper also explores to what extent instruments and mechanisms for sector finance that are successful in developed countries can be replicated in developing countries and economies in transition. The discussion of financing for the energy sector in Panayotou's paper is extended by the article by Norbert Wohlgemuth and Jyoti Painuly of the United Nations Environment Programme Collaborating Centre on Energy and Environment, Denmark, on the financing of renewable energy technologies. The authors demonstrate the importance of introducing innovative mechanisms for the financing of these technologies and emphasize that governments need to play a supportive role in this regard.■

OPENING ADDRESS

The Honourable Chrisanthus Okemo, E.G.H.*

LADIES and Gentlemen, it is my pleasure to join you this morning to officiate the opening of the Fifth Expert Group Meeting on Finance for Sustainable Development Issues of Agenda 21. However, before I make my brief comments, on behalf of the Government and the people of the Republic of Kenya, and on my own behalf, let me welcome you to Kenya and wish you a nice and memorable stay. I especially welcome those of you who have travelled from outside Kenya. I would also like to thank the sponsors of this important meeting, the governments of The Netherlands, Ireland and Kenya, for their support.

Mr. Chairman, the Government of Kenya appreciates the significant role this meeting can play in preparation for the 10th Session of the Commission on Sustainable Development (CSD), to be held in the year 2002. It is expected that this meeting will aim to provide the CSD with the analytical basis and a set of action-oriented policy options for discussions on financing sustainable development.

Looking through the Agenda, this Meeting is scheduled to discuss issues of great interest to developing countries, particularly those of Sub-Saharan Africa. On the subject of improving the policy framework for sustainable development finance, the Sub-Saharan region is facing major challenges. This is because we are struggling to improve an environment that is saddled with many problems and diminishing resources. While some of the problems are regionally based, others arise from the fast changing global scene. For example, only a few countries qualify for the enhanced Highly Indebted Poor Country (HIPC) debt initiative. The impression one gets is that to qualify for HIPC, the country must first fall into intensive care, financially. In other words, the HIPC initiative does not provide for pre-emptive relief. Unfortunately, even for those countries that qualify, the process is such that it takes a long time before the flow of resources arrives and begins to provide relief.

The situation in this region is compounded by the rapid decline of official development assistance resources. Indeed, for many countries, including Kenya, the region is now a net exporter of capital, which means we pay more than we receive. If this was the only problem, perhaps the situation would have been easy to handle. Unfortunately, this is not the case; since the 1997 global financial crisis the region has also experienced a net outflow of private capital. Furthermore, over the past three years, commodity prices have fallen as the financial crisis spread, reducing the export earnings of the region.

In addition, the region seems to have been a victim of the fallacy of the composition. Consequently, as the developing countries have strived to deregulate and privatize public enterprises, it has become a buyers market. The potential buyers of these enterprises have a wide choice and can now dictate the price. Obviously, there are many things the countries of the region can and are doing to improve the environment for development finance. For example, we can and are improving the capacity of the public sector to deliver public services, we are also developing strategies for better use of public finances while improving economic governance. We have removed, and will continue to remove, unnecessary regulations that frustrate investors. In all these efforts, we are demanding greater accountability and transparency of the Government and opening areas previously reserved to public monopolies, such as energy, telecommunications, etc., to private sector investors. All these can and will help. However, the challenge is enormous.

We are taking initiatives to integrate planning and budgeting in an effort to make development finance more sustainable. In this context, we seek to bring development finance into the mainstream of the policy-making arena. As we do this, we face major resource constraints. Indeed, managing this process would have been hard enough without the pressure from globalization of world trade that is threatening our producers, not only in export markets but also in the domestic market. The process of economic globalization poses an additional challenge in that even as we seek to mobilize additional resources from domestic sources, local savings are already being squeezed to finance adjustments for the private sector. For us, the challenge is even greater in that, in our efforts to remain current on our external debt, we have increased domestic borrowing to finance shortfalls in

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external flows.

Mr. Chairman, it is in this context that we find this meeting to be of critical importance to us and the Sub-Saharan region. We believe Kenya is not the only country in this situation. For this region to effectively address the high incidents of poverty and growing unemployment, it will need to mobilize additional resources, both domestic and foreign. If this meeting can help identify avenues and modalities to help developing countries achieve this goal, this meeting will be a success.

Mr. Chairman, Agenda 21 recognizes official development assistance (ODA) as the main source of external financing for developing countries as reaffirmed by the United Nations target of increasing ODA to 0.7 per cent of donor countries' Gross National Product (GNP). It also recognizes the importance of debt relief for the Highly Indebted Poor Countries (HIPC). In addition, it is recognized that ultimately, the main source of financing sustainable development of a country must come from its own private and public sectors. Therefore, Agenda 21 stressed the importance of policy reforms, economic restructuring, and innovative financing mechanisms. However, since the Rio meeting, the situation has significantly differed from the expectations of Agenda 21.

Resources from ODA have actually declined to 0.27 per cent of donor countries' GNP in 1995. As regards the debt situation, the result has been somewhat mixed with significant progress achieved in the reduction of debt burden of middle income countries through improved economic policies, export performance, debt rescheduling, and new financial instruments. By contrast, the debt burden of low-income countries, especially in Sub-Saharan Africa, has remained unchanged or increased, despite the HIPC initiatives and some success in reducing bilateral debt, partly because of poor export performance.

Mr. Chairman, the most positive and largely unexpected outcome since Rio in external financing to developing countries has been the rise in private capital flows, which more than doubled. However, private capital flows cannot substitute for official development assistance because the poorest countries that need it most receive the least. Another positive development in the international scene has been the evolution of international environment funds such as the Global Environmental Facility (GEF) and the Montreal Protocol Environmental Fund (MPEF). These funds have succeeded in transferring some resources from the North to the South for investments that have global environmental benefits, however, these are modest. Another area of promise but with little progress has been international taxation, which identified some innovative instruments which were proposed and discussed. However, there has been little progress in this area because states are reluctant to surrender taxation powers to international institutions.

On domestic resource mobilization, the trends have been in the right direction but modest and variable. Developing countries have undertaken and continue to accelerate economic policy reforms, trade liberalization and financial reforms with efforts to increase savings and reduce public sector deficits. Those economies which have been successful have attracted foreign capital and mobilized domestic resources. Privatization of state enterprises have enabled public enterprises to access capital and technology for modernization and service improvements. Some countries have also developed innovative instruments to mobilize private sector funds which have been utilized for investments in economic and environmental infrastructure, power generation, water supply and sanitation, waste water treatment, solid waste collection and disposal, and reafforestation.

An encouraging trend since Rio has been the reduction of environmentally damaging subsidies on energy, water, agro-chemicals and land clearing, among others. An increasing number of countries have eliminated or reduced these subsidies leading to more efficient use of these resources. These efforts have reduced environmental degradation.

Ladies and gentlemen, as regards economic instruments such as environmental taxes and charges, significant progress has been made in the understanding and acceptance of their roles both as incentives to reduce environmental degradation and also as a source of revenue for sustainable development. Many developed and developing countries have introduced energy taxes, pollution charges and environmental bonds, among others. Empirical evidence shows that revenues from these sources have not been utilized for environmental investments. This has partially necessitated the establishment of national environmental funds (NEFS). The other reason for the establishment of these funds is the underdeveloped capital markets in developing and transitional economies.

Mr. Chairman, from the performance review of sustainable development finance that I have already alluded to, it is evident that there is a great need for the international community to institute additional efforts to address the challenges posed by chapter 33 of Agenda 21. It is worth noting that this subject was discussed by the CSD at a special session of the

United Nations General Assembly in 1997, more popularly known as "Earth Summit plus 5" or "Rio plus 5". This discussion was greatly facilitated by the work undertaken by the Expert Group Meeting on Financial Issues of Agenda 21 at its meeting in Santiago in early 1997. It is in this context that I would, therefore, like to underline the significance of this meeting. It is expected that the meeting will develop a set of action-oriented recommendations for consideration by the forthcoming sessions of CSD in the years 2000 and 2002. In your deliberations, it is expected that you will take on board the recommendations of the "Earth Summit plus 5" which concluded as follows:

First, for developing countries, ODA remains a major source of external funding requiring intensified efforts to reverse the downward trend of ODA. At the same time, all countries should address the underlying causes of this trend.

Second, private domestic and foreign capital is a major tool of economic development which requires governments to ensure a stable macro-economic environment, open trade and investment policies, and well-functioning legal and financial systems.

Third, financing the implementation of Agenda 21 will come from countries' own public and private sector resources. This requires developing appropriate policies for promoting domestic resource mobilization, including as prerequisites reforms to achieve a sound macro-economic environment, reform of existing subsidies, promotion of personal savings and access to credit. This meeting should examine these conclusions and evaluate their appropriateness in light of the fast changing global situation.

Ladies and Gentlemen, it is expected that at the end of this meeting some tangible results composed of actionable policy options will emerge for consideration by the CSD in its subsequent sessions in the year 2000. Therefore, this meeting should facilitate the work of the forthcoming CSD to enable considerable progress to be made in the areas of:

- Updating the impact assessment of the lack of financial resources and heavy external debt problems on the implementation of Agenda 21 in countries in Sub-Saharan Africa;
- Evolution of an actionable strategy to reverse the decline of ODA flows to Sub-Saharan Africa;
- Formulation of a policy strategy to attract increased flows of foreign private capital;
- Assessment of the role environmental taxes and charges could play in Sub-Saharan Africa;
- Suggestions of how policies for increasing the mobilization of financial resources for sustainable development could be integrated into the mainstream policy formulation;
- Proposals of how environmental finance schemes could be made more consistent with wider principles of economic and social policies and strategies;
- Achievement of significant progress on the issue of increasing the flow of ODA to all developing countries, not only by expressing commitment to the agreement reached at the Earth Summit but also working on developing and updating a strategy for translating the agreement into resources flows;
- Undertaking an in-depth consideration of issues concerning contribution and effects of foreign portfolio investments to sustainable development;
- Preparing a proposal for both developed and developing countries on the need for addressing the issue of subsidies in tandem with other economic, social and environment policies as well as their impacts on international trade;
- Undertaking an assessment of the prospects of more comprehensive environmental tax reform and the role that these taxes could play in developing countries in the foreseeable future; and
- Encouraging discussions on the need for increased environmental investment by the private sector given the inherent financial resource limitations of the public sector.

Ladies and gentlemen, these are major issues which require your full attention, discussions, and linkage to finance for sustainable development. No doubt, the task before you is great, however, given the high level of expertise present in this room, the team is more than equal to the challenge. I am, therefore, confident that excellent results will be achieved at the end of this meeting. I wish you very fruitful discussions.

Ladies and gentlemen, it is now my pleasure to declare this Fifth Expert Group Meeting on Finance for Sustainable Development officially open.■

WELCOMING ADDRESS

Jorge Illueca*

MR. Chairman, Distinguished Participants of the Meeting, Ladies and Gentlemen; Dr. Klaus Töpfer, the Executive Director of the United Nations Environment Programme (UNEP) wanted very much to be here with you today to launch this important Fifth Expert Group Meeting on Finance for Sustainable Development. However, he has to be present in Seattle at the launch of the next round of global trade talks. The environment is emerging as a key issue to be addressed during those discussions—in particular, the scope and extent to which environmental considerations will or should be incorporated in the new negotiations. Notwithstanding this, UNEP attaches great importance to this meeting and therefore Mr. Töpfer requested me to represent UNEP and to convey to you his support and commitment to what you intend to achieve during these deliberations.

This Expert Group Meeting is key to providing the Commission on Sustainable Development (CSD) with the analytical basis and policy options that will be discussed as part of its deliberations on the financing of sustainable development. We must also bear in mind that it will also contribute to the substantive preparations for the 10th session of the CSD in 2002, which will review progress since the United Nations Conference on Environment and Development in Rio de Janeiro in 1992.

To meet existing and impending environment and development requirements, practical and innovative thinking about revenue generating mechanisms and market incentives to bring a greater financial contribution to the environmental component of the environment and development package is required.

This practical and innovative thinking must take into account the experiences of the past decades, which show, if anything, that the causes of environmental destruction lie in poverty and in misguided development. They lie in mismanagement of natural resources, in inequity, in unfavourable terms of trade, in debt burden and in agricultural and energy subsidies. They also lie in the barriers to the transfer of technology and know-how and in short term economic planning that views natural resources and ecological processes as free goods and that does not provide due regard to the depletion and degradation of the environmental and natural resources stock.

The Fourth Expert Group Meeting in 1996 reached three broad conclusions in relation to the trends in finance for sustainable development since Rio. Firstly, the interest and activity in relation to developing innovative instruments had risen. Secondly, both official development assistance (ODA) and domestic resource mobilization have fallen far short of the commitments made at Rio. And lastly, that private flows of financial resources from developed to developing countries have expanded enormously. Foreign private capital has become the dominant source of capital for many developing countries, especially those in Asia and increasingly those in Latin America.

In the area of foreign private capital flows the Meeting reported that these flows had grown rapidly since Rio but had shifted from commercial lending towards foreign direct investment (FDI) and portfolio investment. This trend has continued and the UNCTAD 1999 World Investment Report advised that although FDI flows to developing countries declined in 1998 that decline was confined to a few countries. Technology flows, as measured by technology payments, continued to grow, partly reflecting the increased importance of technology in the production process.

The trend towards the liberalization of regulatory regimes for foreign direct investment continued, often complemented with proactive promotional measures. Out of 145 regulatory changes relating to FDI made during 1998 by 60 countries, 94 per cent were in the direction of creating more favourable conditions for FDI.

The testing of new policy approaches has many dimensions and I would urge you in your deliberations to consider a wide inclusive approach in this meeting. For example, various private and public organizations estimate FDI flows. However, there are differences in the estimates made by different institutions for the regions or countries they cover. These differences arise from differences in the time of year at which estimates are made and different methods of

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estimation. UNCTAD estimates that FDI flows to developing countries and Central and Eastern Europe as a whole were $183 billion in 1998, whereas J.P. Morgan, for example, estimated flows to a group of selected developing countries and Central and Eastern Europe countries to be US $101 billion.

This simple example illustrates the difficulty of interpreting the signals of change and reporting the consequences of such change. Your challenge over the next four days in the complex area of the assessment of differing policy approaches is to read and interpret the trends so as to inform policy-makers of national governments. If the existing signals are unclear, such as through lack of data collection as suggested by the IPCC special report on technology transfer, then that message must be given to governments, along with proposals to improve such collection.

In the field of innovation we have seen continued and continuing development, particularly in relation to the Kyoto Protocol, on global warming and the market instruments embodied within the Agreement. The specification of binding commitments for industrialized nations to reduce their emissions of greenhouse gases offers an excellent opportunity to highlight how economic instruments can help realize the objectives of these agreements.

In addition to the creation of energy taxation schemes at the national and regional level that seek to internalize the costs of global warming, there are a number of other market incentives being created at a national level. There is an embryonic carbon trading system being developed by the private sector, ahead of national governments agreeing upon the modalities for such trading on an international level. Additionally, we see the creation of corporate bond issues, which seek to capture the environmental, as well as the financial attributes of an enterprise, and the World Bank has launched its US$150 million prototype Carbon Fund.

The World Bank has estimated that developing countries alone, over the next four decades, will require five million megawatts of new electrical generating capacity to meet anticipated electricity needs. This new capacity will require approximately five trillion dollars of new investment. If renewable energy technologies can capture several per cent of that market, we are looking at a potential for several hundred billion dollars of renewable energy technology sales worldwide and creation of many new jobs over the next decades.

We have high expectations for this Meeting. The United Nations Environment Programme has a special and abiding interest in sustainable development finance. We started working with forward-looking institutions in the financial services sector at the beginning of the decade and launched the UNEP Statement by Financial Institutions on the Environment and Sustainable Development at the time of the Rio conference. More than 170 financial institutions have now publicly endorsed the principles of sustainable banking and more than 80 major insurance or reinsurance concerns have endorsed a similar commitment to the environment for the insurance industry.

The economic rewards of placing environmental concerns high on the agenda are considerable. Socially responsible investment is growing at a much faster rate than the market as a whole and the interdependence of environmentalists and business is making itself more and more evident.

We have much to gain from your perspectives on the subject. This Meeting offers us a new opportunity to step out boldly from the cocoons of our disciplines to confront the various aspects of market instruments in all their complexity, and furnish cogent and creative solutions that can help governments in their drive towards sustainable development. We count on your support and the support of governments in our deliberate efforts to face the challenges — daunting as they are — that lie ahead of us.

Once again, I would like to welcome you to this meeting and wish you an intellectually stimulating discussion in looking at practical ways of creating a new architecture within which we can stimulate sustainable development finance. There is a full agenda and while the presentations may be relatively short I am sure the discussions that follow will embrace all the aspects of policy creation and implementation. I wish you well and look forward to learning of the results of your deliberations.■

INTRODUCTORY STATEMENT

Ron Lander*

YOUR Excellency, ladies and gentlemen, It gives me great pleasure to represent my Government at the Fifth Expert Group Meeting on Finance for Sustainable Development. This Expert Group has a reputation to maintain. The first four meetings were very good and they have had a valuable impact on discussions at the Commission for Sustainable Development. Rightfully so; it is not often that a group of experts of this level from academia, international organizations, governments, banks and NGOs has a chance to discuss an issue that is so essential to sustainable development. It is easier and more common to discuss the *concept* of sustainable development than to discuss its *financing*. And it is not too often that you find something that is even more complicated than the concept of sustainable development!

This is the first meeting of this Group in Africa. And it was about time. In fact, the only condition that we imposed upon the United Nations when we decided to finance this Meeting was that it should take place in Africa. The experience of the past four Meetings shows that regional issues and, more importantly, regional views and perspectives emerge during these Meetings. Of course, we are all experts and we all know what is good for the world, including Africa, but to be honest, there was not much opportunity for African voices to be heard at the past Meetings. I am sure that this Meeting will benefit from the African expertise in this room and that the documents to come out of this Meeting will therefore even be richer than on previous occasions.

The discussion on finance for sustainable development in the Commission on Sustainable Development (CSD) tends to be too much of a discussion on Official Development Assistance (ODA). I hope we can help the CSD to get beyond this discussion. Don't misunderstand me: I am not saying that ODA is not important; it is and it will be for quite a while from now. My Government therefore will maintain its present level of 0.8 per cent of our GNP for ODA. We would truly wish to see all other donors reach the internationally agreed target of 0.7 per cent. Although I am realistic enough not to expect much progress here, we should not let any country that accepted this target off the hook. But this is not the end of the discussion. And it is not even the most relevant part of the discussion. ODA is not going to solve the world's problems and the discussion should be as much on the use of ODA as on the levels of ODA. Foreign direct investment is becoming more and more important. I strongly disagree with those who for that reason say that ODA can go down. The discussion should focus on how we can make ODA instrumental in making foreign direct investment reach more countries than it does today. The discussion should also focus on how to make sure that FDI is sustainable. And the discussion should have an open eye for those countries where significant levels of FDI are not foreseeable in the near future. For those countries it may take even longer before we can start to not worry about declining levels of ODA.

I have said enough about ODA for the moment. I'm sure that ODA and the prerequisites for making it work, such as good governance, will get due attention in the upcoming meeting on Financing for Development in New York. As Agenda 21 says, the largest part of funding for sustainable development has to come from domestic sources. In this respect we all still have enough homework to do, industrialized and developing countries alike. Tax systems are not always beneficial to sustainable development, to say the least; neither are subsidy schemes. Allocation of government budgets can improve in that sense. Legislation is not always the best for reaching sustainable development. The same goes for the formal distribution of responsibilities. The societal costs of all these issues are not easy to identify, but they do exist. And the costs for reaching sustainable development are much higher if they have to compensate for these issues. In that sense it is all a matter of getting the prices right. Getting the prices right is not distorting economies, it is getting rid of existing distortions. This Group should get that message across and, more importantly, should provide concrete guidance on how to do this and guidance to the right actors.

This Meeting is important. But there is another

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meeting going on in Seattle that may even be more important for sustainable development. We can say what we want over here and in the CSD, and we may be absolutely right. But are we talking to the right people? Are we satisfied when the CSD report for 2000 is even better than the previous seven? Or are we satisfied when our delegations to the WTO use our documents? Or our ministers of finance? In order to make a difference, we will have to make sure that what we are saying here during these few days is not just right, but convincing and operational and has an open eye for what is considered important outside, in the real world.

My biggest frustration with sustainable development is that the concept has been kidnapped by environmentalists. Rio was not just about the environment, it was about the environment and development. Some of the documents that will be presented here have sustainable development in their title, but only environment in their content. That is a very recognizable phenomenon. Not many OECD countries send their ministers of development cooperation to the CSD anymore, they send their ministers of environment. From developing countries, we seldom see ministers of finance or planning. We should change that. We have allowed the agendas for the environment and for development to drift apart again, leading to silly discussions about sustainable *economic* development or about *environmentally* sustainable development. In our discussions, we will have to force ourselves to respect the concept as it was used by the Brundtland Commission, encompassing environmental, social and economic development. Otherwise, sustainable development may end up as we all do in real life: we are born wet, slippery and ugly and from there it only gets worse.

In short, I hope that we will be able to be analytically correct, concrete, action-oriented and follow an integrated approach. That is a lot to ask, I know. There is a saying in The Netherlands that one fool can ask more than ten wise men can answer. I have played the fool. Now it's up to you.■

INTRODUCTORY STATEMENT

Dympna Hayes *

I would like to begin by saying how pleased the Irish Government is to have had the opportunity to co-sponsor this Meeting with the Governments of Kenya and the Netherlands. I would also like to express our appreciation to the United Nations Environment Programme (UNEP) for hosting the meeting and to the United Nations Department of Economic and Social Affairs (UNDESA) for its organization. On a personal note, I would like to thank UNDESA for inviting me to attend this Meeting and also say how much I look forward to working with all of you over the next few days.

This Fifth Expert Group Meeting on Finance for Sustainable Development is continuing in its role as the preparatory process leading up to each formal discussion of financial issues of Agenda 21 in the CSD. This year's meeting of the CSD has before it for consideration the cross-sectoral theme of financial resources, trade and investment and economic growth.

The theme is certainly timely given this week's ministerial conference of the World Trade Organisation (WTO) in Seattle. The storm of protest in Seattle is delivering the clear message that many believe that globalization has not delivered on its promise of better lives for ordinary people. What is coming through loudly and clearly is that there is a strong perception that unchecked globalization can undermine consensus on open economics and societies, leading to growing political instability which, in turn, could threaten trade, investment and economic development.

If the global economy cannot be made to work for all, it will lose legitimacy in the eyes of the people of developed and developing countries alike. Harnessing the forces of globalization for the benefit of all requires action at both the national and international levels.

Economic development will promote sustainable development only when it leads to:

- increased material welfare and quality of life for everyone;
- a reduction in poverty; and
- resources for environmental protection and management.

Sustainable growth is not simply a function of investment, production and trade; it must rely also on a safe and stable environment and on good governance. Governments must work nationally and cooperate internationally to:

- pursue policies which enable those in poverty to share more of the benefits of economic growth;
- assess the sustainability of economic growth by monitoring more closely the impacts of growth on environmental and natural resource capital; and
- internalize environmental externalities using an appropriate mix of instruments.

Like our partners in the European Union, Ireland is fully committed to development cooperation and to the provision of resources to address development challenges. We have been steadily increasing our expenditure on ODA — our ODA budget has more than quadrupled in the course of the last six years. The European Union is also fully supportive of the High-level Discussion on Financing for Development which is taking place in New York at the moment.

However, most financial resources for development will come from domestic and foreign private sources. Countries should, with donor assistance where appropriate, create an environment which encourages domestic and foreign investment on suitable terms. This enabling environment should include in particular a sound macro-economic framework, participatory development and efforts to fight corruption. Public-private partnerships could also be explored across a wide range of development assistance fields to identify potential new and innovative sources of finance.

Finally, the question of the more effective use of financial resources should also be addressed. ODA must be made more effective through, for example, improved allocations between countries and sectors to better reduce poverty, and must be targeted on the poorest countries who are pursuing effective strategies to achieve sustainable development.

The need for, and importance of, coordination is continually stressed in the United Nations. However

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this is a principle which should also be taken on board by the donor community. Better co-ordination of donor efforts, using, for example, the United Nations Development Framework and the Comprehensive Development Framework of the World Bank, would do much towards achieving a holistic approach to poverty eradication. We also need better performance measurement through the elaboration of indicators to measure quality as well as quantity of development assistance.

I look forward to the discussion of these themes over the next few days.■

INTRODUCTORY STATEMENT

JoAnne DiSano [*]

HONOURABLE Minister, distinguished representatives of Kenya, donor countries, international organizations, ladies and gentlemen; I have the honour of presenting a statement on behalf of Ms. JoAnne DiSano, Director of the Division for Sustainable Development of the United Nations Department of Economic and Social Affairs. Ms. DiSano has asked me to express her regrets for not being available to attend this meeting because of other commitments.

First, I wish to express my thanks and appreciation to the Government of Kenya and the United Nations Environment Programme (UNEP) for their kindness and generosity in hosting this Fifth Expert Meeting on Finance for Sustainable Development. At the same time I would like to thank the sponsors of this meeting, the Governments of the Netherlands, Ireland and Kenya, for their generous support. Finally, I would like to thank the policymakers and experts from Africa and other regions for their participation in this meeting.

The brief comments which I would like to make fall under three headings. First, I would like to comment on the reasons behind the current revival of the international debate on finance for development.

Next, I would like to illustrate how this Expert Group and the United Nations Commission on Sustainable Development (CSD) have taken into account the broad concept of sustainable development in their discussions on financial issues. This concept, as you are aware, emphasizes the need for pursuing simultaneously economic, social and environmental objectives, recognizes the interdependence of specific developmental policies, assigns the state a vital role, and stresses the importance of processes such as public-private partnerships.

Finally, I would like to suggest that starting with this Meeting the Expert Group on Finance for Sustainable Development will put greater emphasis on the link between capacity building and the implementation of policy reforms.

Let me elaborate briefly on the first point, the revival of the international debate on finance for development.

As you are aware, in the last two or three years the international debate on development has moved the issue of finance to centre stage. Let me give you two examples. In 1997, Governments reiterated the key role of financial resources and mechanisms for the implementation of Agenda 21 at a Special Session of the United Nations General Assembly, the so-called "Earth Summit+5". Furthermore, in November of this year the General Assembly decided to convene a high-level International Conference on Financing for Development, to be held in the year 2001.

There are a number of reasons for the current revival of interest in the financial issues of development:

The international financial crisis, which started in East Asia in 1997, caught policy-makers by surprise. Subsequent analysis revealed that there were some serious flaws in the financial infrastructure of several developing countries and that the international financial architecture also required some alterations.

Another important reason for the increased interest of policy-makers in the issue of development finance is that against the backdrop of rapidly changing production technologies, intensified international competition in export markets and growing environmental constraints, much larger injections of capital for the modernization and industrialization of developing country economies are needed than was assumed at the beginning of the 1990s.

A third reason for the increased interest in the issue of finance is that policymakers are aware that implementing the concept of sustainable development will require a number of further reforms of the national and international financial architecture. As you know, in recent years important work has been undertaken in further refining the concept of sustainable development by international organizations. In this regard, I would like to highlight the work of the OECD on indicators and the work of the World Bank on conceptualizing a comprehensive framework of development. Guidance for implementing the necessary policy reforms will come from various sources, in particular the agreements reached at the several global

[*] JoAnne DiSano is Director, Division for Sustainable Development, United Nations Department of Economic and Social Affairs. This speech was delivered on her behalf by Juergen Holst, Chief, Finance, Industry and Trade Unit, Division for Sustainable Development, United Nations Department of Economic and Social Affairs.

conferences of the United Nations in the 1990s.

I will now turn to the second point I would like to address, namely the extent to which the new thinking on development that is subsumed under the concept of sustainable development is reflected in the discussion on finance of this Expert Group and the deliberations of the CSD.

The concept of sustainable development recognizes that in addition to the traditional objective of economic growth, development has many other equally important objectives in areas such as social welfare and environmental protection. It is recognized that the Earth Summit in 1992 pioneered the development and endorsement of this broader set of developmental objectives and that the CSD discussion on finance in the follow-up to the Earth Summit has reflected this approach. For example, in its discussion on ODA the CSD reviewed the shift of focus to technical co-operation projects aimed at poverty alleviation and environmental protection, and in regard to international financial flows the CSD discussed the impact of foreign direct investment (FDI) on labour conditions and environmental degradation. Furthermore, based on Agenda 21 the CSD has regularly discussed the adequacy of financial resource allocation for various sectors and how resource flows could be increased through innovative mechanisms.

The concept of sustainable development recognizes also that development policies are interdependent. This applies to a number of financial policies. For example, the CSD concluded that in many cases policies aimed at increasing the inflow of private foreign capital would at the same time be beneficial for stimulating domestic private investment in sustainable development projects.

Moreover, the concept of sustainable development recognizes that governments play a vital role in development. This also applies to the role of government in the mobilization of financial resources for sustainable development. The CSD highlighted, for example, the important role of governments in institution building for financial sector development.

Finally, the concept of sustainable development recognizes that processes are as important as policies and emphasizes the particular importance of partnerships and other arrangements between government and the private sector. In regard to the mobilization of financial resources for sustainable development the CSD has advocated, for example, the leveraging of ODA through public-private co-financing arrangements.

I believe that these examples show clearly that the discussion at the CSD on finance for sustainable development has kept pace with the new thinking on development.

As far as finance for the protection of the global environment is concerned, the CSD has taken note of the financial assistance made available to developing countries through the Global Environment Facility (GEF) and other financial mechanisms of the major multilateral agreements. However, the CSD has not examined their adequacy in any great detail since this would duplicate the work of other intergovernmental bodies.

The third major issue that I would like to address is the need for donors and international organizations such as the United Nations Development Programme (UNDP), the World Bank and Regional Development Banks to become more supportive of national capacity building aimed at facilitating the increased mobilization of national and international resources for sustainable development. I would therefore like to ask this Expert Group to discuss in more specific terms than in the past the ways in which donors and international organizations could strengthen their support for national initiatives aimed at capacity building for improving the mobilization of financial resources. This could enable the CSD to better reflect the issue of capacity building in its policy recommendations and thus create a stronger link between policy development and the assessment of technical cooperation needs.

As you are aware, the work on policy development and capacity building of this Expert Group is expected to provide important inputs to the debate of the CSD on financial instruments and mechanisms for the financing of Agenda 21 at its 8th session in April 2000, which will be preceded by an intersessional meeting of the CSD in February next year in New York. The debate on finance at its 8th session is part of the 5 year work programme of the CSD which was approved at the Earth Summit + 5 in 1997. The CSD will resume its general debate on finance in 2002 when it will assess the implementation of Agenda 21 in the first 10 years after the Earth Summit.

This meeting and the forthcoming 8th session of the CSD are also expected to provide inputs for the International Conference on Financing for Development to be held in the year 2000.

I am confident that the work that you will undertake at this meeting will fully meet the expectations of the CSD and look forward to receiving the assessment and recommendations that result from this meeting with its focus on "Testing new policy approaches".■

CHAIRMAN'S REMARKS

Lin See-Yan*

LADIES and gentlemen, first, let me extend a warm welcome to all of you to the Fifth Expert Group Meeting on Finance for Sustainable Development. I should take this opportunity to thank the sponsors of this Meeting, the Governments of the Netherlands, Ireland and Kenya for their generous support and commend the host, the United Nations Environment Programme (UNEP), for its hospitality. I should also thank the organizer of the meeting, the United Nations Department of Economic and Social Affairs, for developing the substantive concept of the meeting and taking care of its organization.

The main purpose of this meeting is to assist the United Nations Commission on Sustainable Development (CSD) in advancing the debate on mobilizing financial resources for sustainable development at its eighth session scheduled for April 2000, which will be preceded by an inter-sessional meeting of the CSD to be held in February next year in New York. The last time the CSD debated the issue of financial resources for sustainable development was at a Special Session of the United Nations General Assembly in 1997. You will recall that the more popular name of the special session was the "Earth Summit plus 5" or "Rio plus 5" because it reviewed the implementation of Agenda 21 five years after the Earth Summit in Rio.

No doubt, the General Assembly's assessment of progress made in the mobilization of financial resources since the Earth Summit was greatly facilitated by the technical work undertaken annually by the Expert Group on Finance for Sustainable Development, particularly its Report emanating from the Fourth Meeting held in Santiago, Chile, in early 1997. For our purpose, I would like to highlight three of the major conclusions of the Assembly's assessment which, I think, are relevant for us to keep in perspective in our work here in Nairobi.

First, for many developing countries, particularly those in Africa and the least developed countries, ODA remains the main source of external funding; it is essential for the prompt and effective implementation of Agenda 21 and cannot be replaced by private flows. Hence, intensified efforts should be made to reverse the downward trend of ODA, and the underlying causes of this adverse trend should be addressed by all countries in the spirit of global partnership.

Second, private domestic and foreign capital act as a major stimulus to spur economic development and to encourage higher levels of private investment. Governments should aim at fostering a conducive environment through ensuring macroeconomic stability, implementing open trade and investment policies, and instituting well-functioning legal and financial systems. To ensure that private foreign investment is supportive of sustainable development objectives, it is essential that the national Governments of both investor and recipient countries provide encouragement, helpful regulatory frameworks and incentives for private investment.

Third, while international cooperation is very important in assisting developing countries in their development efforts, in general a significant part of the financing to implement Agenda 21 will, in the end, have to come from countries' own public and private sectors. Policies for promoting domestic resource mobilization for sustainable development must be decided by each country and should encompass sound macroeconomic reforms (including fiscal and monetary policy reforms), review and reform of existing subsidies, and the promotion of personal savings and ready access to bank credit.

Ladies and gentlemen, the agenda of this Meeting will focus on testing new policy approaches for the mobilization of financial resources for sustainable development. In this regard, the agenda has been so structured to take into consideration the main conclusions of the 1997 "Earth Summit plus 5" as well as important developments that have occurred after 1997, such as changing perspectives on ODA, the reversal of foreign private short-term capital flows and rising foreign debt in the aftermath of the financial crisis in Asia, and recent policy reforms aimed at improving the mobilization of financial resources for sustainable development.

The papers that have been prepared for this meeting are intended to provide a solid technical basis for discussion, and it is our goal to bring to the attention of the CSD a number of important policy issues and

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options that have not been (or have not been sufficiently) dealt with in the past.

I am confident that our inputs to the forthcoming session of the CSD will enable the Commission to make significant progress on at least eight important policy areas:

First, the CSD will have an opportunity to take into consideration a number of issues in financing sustainable development that are particularly critical for countries in Sub-Saharan Africa. In this regard, I expect the CSD to be in a better position to update its assessment on how the lack of financial resources and insufficient debt relief have delayed the implementation of Agenda 21 in countries in Sub-Saharan Africa. Furthermore, the CSD is expected to spell out particular strategies which may be required to reverse the decline in ODA flows to Sub-Saharan Africa and to adopt a clear policy package approach to attract an increased flow of foreign private capital, especially FDI. In addition, a review of the role which environmental taxes and charges could possibly play in Sub-Saharan Africa would be useful.

Second, I expect the CSD to discuss the dilemma of public policies aimed at effectively integrating the mobilization of financial resources for sustainable development into mainstream policymaking in more detail than it has done so in the past. In this context, it will be important to focus on the core problem of how to make environmental finance schemes consistent with the wider principles of economic and social policies, and develop the needed institutional coordination mechanisms for such integration.

Third, I expect the CSD to make significant progress on the issue of increasing the flow of ODA to all developing regions. It is now generally acknowledged that reversing the decline of ODA requires not only a commitment to the agreements reached at the Earth Summit but also continuing work at developing and updating the strategy for effective implementation. I hope that the CSD will be able to come up with a number of definite proposals on how best to update the strategy on reversing the decline of ODA that it endorsed at the "Earth Summit plus 5" in 1997.

Fourth, I expect the CSD to undertake an in-depth discussion on the contribution of foreign portfolio investment to sustainable development. The Asian financial crisis has amply demonstrated the potential for volatility in foreign portfolio investment flows and their negative impact on sustainable development. These financial flows certainly deserve greater attention by the CSD.

Fifth, in view of the severe negative impact of unsustainable external debt burdens, I expect the CSD to make a significant contribution to the most recent initiatives for debt relief and provide credible answers to key questions such as: Will the enhanced HIPC initiative lead to sustainable debt levels? Is the moral hazard problem of cancelling poor countries' debt exaggerated? And what is the contribution of debt relief to initiating and sustaining a poverty reducing development strategy?

Sixth, I expect the CSD to be in a position to suggest that both developed and developing countries need to change their current approach and mindset in tackling the issue of subsidies in isolation of other economic, social and environmental policies. The CSD will have to make a clear and convincing case for undertaking subsidy reforms as part of a wider programme of macroeconomic, social and political reform.

Seventh, as far as environmental tax reforms in developed countries are concerned, I expect the CSD to assess the prospects for more comprehensive environmental tax reforms in these countries and arrive at a realistic assessment of the role that environmental taxes could possibly play in developing countries in the foreseeable future.

Finally, I expect the CSD to continue to remain committed to its initiative to actively promote discussion on the need for increased environmental investment by the private sector. Given the scale of global environmental needs and the fact that public sector flows are not likely to increase substantially, private capital is increasingly being recognized as the primary instrument for financing sustainable development. However, for the private sector to play its full part, it must be recognized that environment friendly investment must be commercially attractive.

Ladies and gentlemen, in view of the high expectations on the outcome of the forthcoming CSD debate on finance for sustainable development, the challenges before this Expert Group are real, serious and difficult. However, given the composition and expertise of this Group and the pleasant work environment provided by this conference centre, I am sure that we will all rise to meet the challenges head-on and, at the end, will not disappoint in providing valuable inputs to the CSD.■

CHAIRMAN'S SUMMARY AND RECOMMENDATIONS

*Lin See-Yan**

OVERVIEW

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, organized by the United Nations Department of Economic and Social Affairs (UNDESA) and hosted by the United Nations Environment Program (UNEP).

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 mobilization 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.

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 organizations (NGOs), government ministries, and international institutions. The participants expressed their personal opinions as experts, and not necessarily the viewpoints of the organizations 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.

The Meeting recalled that sustainable development is characterized 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.

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 recognized 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.

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 organized 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 fi-

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nance. The final section contains some proposals for future work on finance for sustainable development.

RECENT TRENDS IN FINANCE FOR SUSTAINABLE DEVELOPMENT

While the Fourth Expert Group Meeting in Santiago (Chile) in 1997 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.

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.

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.

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 realized.

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.

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 per cent in 1994-1997, compared with an average annual rate of about 2.0 per cent 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.

INTEGRATION OF ENVIRONMENTAL FINANCE INTO MAINSTREAM PUBLIC FINANCE

The policy framework for the mobilization 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 mobilizing 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.

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.

An important issue in designing the policy framework for the mobilization of domestic financial resources is the integration of environmental finance into mainstream public finance. Implementing the environmental component of sustainable development goals requires cooperation between various ministries, in particular the ministries of finance and environment. Many times, cooperation 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.

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 equalized. Allocative efficiency is most likely when government revenue allocation is determined in an atmosphere of transparency and accountability.

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.

NEW POLICY APPROACHES IN INTERNATIONAL FINANCE

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.

In general, new policy approaches to international finance, both public and private, must take into account the impact of globalization 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 globalization also needs to take into account the implications of the Asian financial crisis for sustainable development.

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.

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.

Official Development Assistance (ODA)

Defining a new policy agenda

It was noted that the Earth Summit+5 in 1997 called for working out strategies that would increase donor support for aid programmes and revitalize the commitments that donors made at UNCED in 1992. At the Fourth Expert Group Meeting in Santiago, Chile, three elements of a new aid strategy were emphasized. 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 coordination to reduce the risk of programme duplication and programmes working at cross-purposes.

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 globalization, 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 characterized the first half of the 1990s when private flows to emerging markets soared. Furthermore, the benefits of globalization in terms of employment and wealth creation have been disproportionately 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.

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 per cent of GNP Rio commitment should do so as soon as possible.

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.

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 emphasized 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.

Finally, in order to better use ODA to facilitate the integration of developing countries into the process of globalization, 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 marginalized. And somewhere in between are the developing countries that face both forces of integration and marginalization (countries that are prone to bouts of integration and exclusion).

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 sectors. 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.

ODA and sustainable development in Sub-Saharan Africa

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 per cent.

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 coordination and management could be improved in various ways:

- At the national level, African governments could increase their cooperation with aid distribution agencies. In addition, checks and balances are needed to coordinate 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 utilization 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.

Debt

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.

The magnitude of the debt burden of HIPC countries, most of which are in Sub-Saharan Africa, has been well documented. Recognizing 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.

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.

Foreign Direct Investment and Foreign Portfolio Investment

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.

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.

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.

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

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.

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.

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.

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 cooperation between different ministries and between government, industry and NGOs.

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 more volatile than FDI.

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

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.

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 harmonization of standards and practices;
- Rationalization 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.

NEW POLICY APPROACHES IN DOMESTIC FINANCE

Subsidies

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 subsidization of key inputs.

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.

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 privatization to subsidy reduction appears to be ambiguous. Privatization tends to reduce subsidization 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 subsidization 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.

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.

Environmental Taxes and Charges

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.

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 coordination may lessen any such effect.

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.

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.

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

Private Sector Participation

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.

In analyzing 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 privatization. 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 emphasized the importance of privatization 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 are fully implemented.

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 emphasized that the whole system of regulations, monitoring and compliance requires capacity-building and greater involvement of civil society.

As to the role of privatization, the important role of the regulatory framework for achieving a positive impact on sustainable development was emphasized. Moreover, it was felt that there is a need to further analyze why a number of privatizations had a negative impact on sustainable development.

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 organizations 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 standardizing 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.

INNOVATIVE MECHANISMS IN SECTOR FINANCE

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 realization 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.

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 decentralization 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.

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.

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.

Renewable energy is generally more expensive for consumers than conventional technology, in part because of fossil fuel subsidies, a failure to internalize 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.

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 amortization and micro-financing schemes have also contributed to increased financial sustainability of the sector.

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. Privatization 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 internalized 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.

Sustainable forestry management, which has traditionally been difficult to finance, has received a financial boost from emerging carbon markets, the Clean Development Mechanism (CDM), bioprospecting 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.

PROPOSALS FOR FUTURE WORK

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

- 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;
- Research is also needed to investigate whether globalization and sustainability goals provide a new and compelling rationale for debt reduction and a rising trend of ODA;
- 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;
- Research should be undertaken on green budget reforms;
- Research should be undertaken on capacity and institution building for the mobilization of financial resources for sustainable development in order to respond better to developing countries' requests for technical assistance;
- In all proposed research work the cooperation of civil society should be sought.

In view of the complex issues related to the mobilization 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.

Finally, recognizing 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. The OECD expressed its interest in co-organizing such a meeting and proposed to convene it at the Regional Environmental Centre in Budapest, Hungary.■