

CHAPTER

9

The financial basis for strategies¹

Introduction

No strategy for sustainable development can succeed without financial backing. This is borne out by the experience of Agenda 21, which lost credibility as the gap between what was required and what was available became more apparent.

The pronouncements and programmes of Agenda 21, though individually reasonable and compelling, when taken together and without a reference to sources of financing, appear little more than a wish list of things good to have but beyond our reach. (Panayotou 1994)

Earlier strategies focused on costing long 'shopping lists' of projects ...

Earlier national conservation strategies (NCSs), national environmental action plans (NEAPs), tropical forestry action programmes (TFAPs) and other strategies also quickly lost momentum, as a crucial part of the system needed for sustainable development – finance – was barely considered. Strategy 'finance' tasks were often limited to adding up the cost of recommended actions and proposing increases in the government budget. While it is important to mobilize finance for a sustainable development strategy, in particular to get the formulation process started, this is not sufficient. As the concept of a sustainable development strategy has moved away from a focus on producing a plan document (often, in developing countries, containing or accompanied by a suite of proposed projects) to a more process-oriented approach, so the financial challenges have changed.

... but now the challenge is to ensure the finance system in general supports sustainable development ...

It is no longer simply a case of mobilizing funds for such projects or activities, with the government in the lead implementing role. A strategy is now seen as being more about setting a vision with broad directions, agreeing the attributes of a path towards sustainable development, and putting in place the key mechanisms. So attention must be given also to the financial mechanisms needed to internalize environmental and social costs in order to achieve the necessary changes in direction (see Chapter 8, which integrates financial or market mechanisms into the list of strategy instruments). Responsibility still lies

¹ The first draft of this chapter was prepared by Maryanne Grieg-Gran of IIED. It has also benefited from review comments and additional material provided by Tariq Banuri (Stockholm Environment Institute, Boston Center) and Nicola Borregaard, Germany.

primarily with government to introduce the required measures, but the aim is also to change financial behaviour, particularly within the private sector; for example, to make polluters and beneficiaries of environmental services pay.

By 1997, most governments had realized the importance of the financial viability of new sustainable development policies. In its 'Five Years after Rio' Report, the World Bank highlighted the need to remove perverse subsidies, impose environmental taxes and apply more adequate user charges as policy instruments that could ensure financial sustainability. These instruments can be complemented by a range of others that can strengthen the financial base for sustainable development strategies: for example, markets for environmental services. Governments need to place less emphasis on financing project implementation and more on establishing frameworks or enabling activities; for example, designing the necessary policy mechanisms or helping certain groups to adjust to the changes required for sustainable development. This means that governments may have to concentrate less on prescriptive regulation and more on catalyzing initiatives, channelling resources or fostering cooperation between actors.

In addition, the decisions made by institutions concerned with finance and investment must be coherent with the goals and directions of the strategy; otherwise the whole strategy process will be undermined. To achieve this, sustainable development must become an integral part of the objectives and operations of investors and financial institutions, and these institutions need to be fully involved in the strategy process from the outset. For example, through providing 'seed funding', financial institutions can play a role in redirecting industry into more sustainable production.

It could be argued that if mechanisms were established to internalize the environmental and social costs of development, the decisions of financial institutions would be aligned automatically with the direction of the strategy. In practice, this is unlikely to happen smoothly because of information failures, transaction costs and problems of enforcement. For this reason, it is necessary to target financial institutions directly, and work with them on analysing the constraints to sustainable investment.

A greater focus on private financial decision-making is essential in both industrialized and developing countries, especially given the trends in capital flows to many Southern countries. For developing countries as a whole, private capital flows were more than four times official flows in 2000 (World Bank 2001a).

The financial basis of a strategy for sustainable development has three dimensions:

- *Mobilizing finance for specific activities* such as strategy formulation, review and framework activities, as well as specific components of the strategy that require specific funding. This is addressed in 'Mobilizing finance' on page 290.
- *Using market mechanisms to align incentives* with the strategy directions (page 298).
- *Mainstreaming sustainable development* within the decision-making and operations of financial and investment institutions, in both the public and the private sectors (page 303).

Scale issues are also important, as strategies for sustainable development can be developed at various levels: national, sub-national and local. At the local level, financial resources are often limited, there are fewer financial options for developing and implementing a strategy and the types of financial institution involved are likely to be different compared with the national level. For example micro-finance institutions may be key players in sustainable livelihoods and small enterprises at the local level. The balance between the three dimensions may also be different depending on the level. At the local level, the emphasis may need to be more on mobilizing finance given the limits on tax setting power that often apply to local government.

This chapter considers the challenges involved in addressing these different dimensions, in both the short and long term and at different levels (national to local).

... which means involving private investors in the strategy process, as well as government

Mobilizing finance

Under the old paradigm (strategies as plan documents, with portfolios of activities), most finance was allocated for project implementation. In the past, in developing countries, considerable donor support has been provided to assist the formulation of strategic plans, but it has proved more challenging to secure finance for implementation. Even where donor support has been secured for specific projects, it has usually been restricted to investment costs, and donors have rarely made a commitment to cover recurrent costs over a long period. Consequently, many projects have not contributed to sustainable development.

The Agenda 21 approach emphasized the need for a substantial flow of new and additional resources to developing countries. The UNCED Secretariat estimated that the average annual costs (1993–2000) of implementing Agenda 21 in developing countries would be over US\$600 billion, including about US\$125 billion/year in grant or concessional finance from the international community (Agenda 21, Chapter 33; www.un.org/esa/sustdev). In reality nothing like this amount was raised.

This experience shows that reliance on the mobilization of large amounts of additional finance, particularly donor finance, for the implementation of a sustainable development strategy is unrealistic. While there is growing pressure on developed countries to increase their official development assistance and, in particular, to meet the target of 0.7 per cent of GDP, there will still be a financing gap. Even if the focus were only on the provision of global public goods, the situation would not be much different. The UN High Level Panel on Finance for Development has recently estimated that ‘beginning to address this need will probably require at least US\$20 billion’ – a sum, which, it states, is about four times the current spending level (UNHLPFD 2001). For this reason, there have been calls to find other ways of mobilizing finance and to rely more on realigning incentives.

The concept of strategies for sustainable development now focuses on processes and systems. The effect of this is to blur the traditional distinction made between strategy formulation and implementation and, by implication, the financial requirements. The processes established for strategy formulation must now be viewed as activities to be maintained indefinitely. The focus of implementation now needs to shift to setting potentially self-financing activities in operation, meeting adjustment costs and only in a minor way funding activities on a long-term basis.

Financial requirements of the strategy

FORMULATION AND REVIEW

If a strategy is to be participatory, country-led and based on comprehensive and reliable analysis (ie meeting the principles and elements for effective strategies set out in Boxes 3.1 and 3.2), then financial resources will be needed in the early stages for research, analysis, consultation, communication, and for the development and maintenance of monitoring and evaluation mechanisms. The kinds of resources required for the strategy processes are set out in Chapter 4, pages 94–95. The costs of these processes should not be underestimated, given the amount of time involved and the need to keep processes going, as the case of Pakistan’s NCS shows (Box 9.1). Nevertheless, the extent to which the strategy is building on previous activities and processes will have an important influence on cost. It is to be expected that the costs of the first strategy iteration will be relatively high, but that the costs and preparation time required for subsequent strategies will be lower.

Moreover, it is not just the government that needs financial resources; other stakeholders also need support so that they can make an effective input. While the costs involved may not always be an issue for the private sector, they may prevent other stakeholders such as NGOs and labour unions from participating. NGOs may need financial assistance to meet the time and travel costs of attending consultation meetings

Finance is needed to invest in effective strategy formulation processes

Box 9.1 Financing the Pakistan National Conservation Strategy

The widely acclaimed Pakistan National Conservation Strategy had a nine-year gestation period. Over three years from 1988, during which the strategy document was prepared, more than 3000 people were involved through workshops and consultation. This level of participation was possible because it attracted donor funding from the outset (from the International Bank for Reconstruction and Development (IBRD), the Canadian International Development Agency (CIDA) and UNDP).

Some concern has been expressed that the product (the NCS strategy document and, subsequently, the portfolio of projects) took precedence over the continuing multi-stakeholder participatory processes, and monitoring and evaluation mechanisms were neglected.

Donors came to believe that the 'process' investment had largely been completed once the strategy document had been approved. Implementation of projects assumed a higher priority for them. Yet this shift dramatically reduced the potential impact of the projects, as there was no longer a strong coordination, monitoring, communications and dialogue facility at the 'centre' of the strategy to keep it on the right path and enable it to evolve.

Source: Hanson et al (2000)

and to conduct the necessary preparation such as independent research. For example, the New Zealand Government made funds available to assist NGOs to take part in the discussion on the 1991 Resource Management Act and also funded some NGOs to undertake commissioned work (Dalal-Clayton 1996).

Expenditure on ensuring effective participation may be costly but may pay off later in ensuring credibility of the strategy (see Chapter 6, especially pages 193–208). This is also shown by experience in New Zealand where public response to the Resource Management Act was much more favourable than to the Environment 2010 strategy which had been formulated in a less participatory manner (Dalal-Clayton 1996). The communication of the strategy (see Chapter 7) is part of the participatory elements and should not be forgotten when designing the budget for the participatory process.

Many of the financial requirements will be, therefore, to build and use strategy mechanisms such as participation and communications. Apart from funding these strategy mechanisms, two other financial tasks are relevant to strategy formulation:

First, the potential environmental, economic and social impacts of strategy recommendations will need to be assessed, including those of proposed new policies and any new financial mechanisms. A key aspect of such impact analysis will be an assessment of the financial sustainability of any new policy tools (analytical tools required for the strategy process are listed in Table 5.1). Some countries have made it obligatory to undertake socio-economic analyses of environmental regulations (although rarely introducing this requirement for other policy areas as well). The case of Chile provides a recent developing country example (Box 9.2).

There is a need to assess the financial implications of all policies and activities recommended by the strategy ...

Box 9.2 Assessing the impact of new environmental regulations

Economic analysis of new environmental regulations was introduced in Chile in 1996. After developing the methodological system for these analyses, by 2001, about ten such analyses had been completed. The studies are carried out directly by the National Commission on Environment or by external consultants, and identify the costs and benefits of the respective new regulation, including the financial requirements falling into the private and the public sector. Very often, the studies have concentrated on the economic valuation of the environmental impacts. However, a change towards more pragmatic indications concerning, for example, the financial sustainability of the regulation, would be useful and policy-relevant, and would not require additional resources.

Source: Borregaard et al (2001)

... and to assess the environmental and social implications of financial instruments

The search for self-financing approaches to implementing a strategy will often suggest market-based mechanisms – but there are limits to what can be self-financed

Donor finance can help – but the implications of donors' favoured 'brands' of strategy process, and their associated conditionalities, should be well understood

Second, the design of financial mechanisms needs to be informed by research on their potential impact on economic growth, the environment and income distribution. In particular, their likely impact on specific groups should be examined and projects developed to help those affected to adjust in the transition period. Before these mechanisms are fully implemented, they will need to be tested in pilot schemes to improve understanding of how they will work in practice.

IMPLEMENTATION

Strategy implementation implies different types of financial activity. In spite of the shift to a process approach, there will still be some activities which will require long-term funding and for which there is limited scope for self-financing: for example, social safety nets or protected areas. Other activities may need financial support in the initial stages but have the potential to be self-financing in the longer term. Examples include fuel switching and the promotion of cleaner production. It is easier to make a case for financing such activities if they are shown to form part of a programme which, in the long-term, will become self-financing. Finally, the implementation of market mechanisms is likely to be self-financing – depending on the balance struck between using them as a means to change behaviour and as a source of revenue. Funds will need to be set aside to monitor the impact of these mechanisms and to redesign them if necessary. Nevertheless, there will still be activities which will require long-term funding and which have limited scope to be self-financing, such as the management of protected areas.

Sources of finance

DONOR FINANCE

To date, most strategy processes in developing countries have been supported by donors, or have been set in motion to meet donor conditions for further support to other activities (eg NEAPs in the mid-1990s). An advantage of donor support is that sufficient funds can be made available that would not normally be provided from the recurrent budget of the ministry leading the strategy, especially for activities not normally funded fully, such as participation. But the downside is where there is pressure (from the donor) to produce a strategy document within a rigid timeframe in order to justify the support provided or to secure future development assistance. This can seriously affect the quality of participation, as in Pakistan (Box 9.1). The Highly Indebted Poor Countries (HIPC) initiative provides for debt relief, subject to the approval of a Poverty Reduction Strategy. It has been noted that there is a tension between securing quick debt relief and preparing a quality strategy with civil society participation (US General Accounting Office 2000). While donors have been willing to support the initial formulation of a strategy document, it has proved more difficult to secure donor funds for monitoring and review. The challenge is to persuade donors to provide financial support for a recurrent process with no predetermined outputs. The trust fund model (see page 296) may be a solution to this problem.

Another issue is that donors have different agendas and priorities, so they have tended to finance different activities or types of strategy. For example, the GEF has concentrated on funding biodiversity action plans in a number of countries. The IMF and World Bank have been promoting PRSs for low-income countries as a condition initially for debt relief under HIPC and, from July 2002, for IDA assistance. The transaction costs involved are considerable – Uganda's PRSP, for example, took over five years to prepare (US General Accounting Office 2000). This is not helped by the fact that donor priorities also change over time as a result of changes in government, or personnel or development fashions. The challenge is to integrate or streamline these various strategies and make more efficient use of donor funds.

Two important aspects need to be kept in mind: timely donor support, correctly provided, can be important for specific issues, and can trigger the mobilization of resources several times greater than the

initial amounts; and a clear indication of potential multiplier effects might help to convince donors of the benefits of their contribution.

Very often, donor finance is channelled through NGOs and does not pass through the government – as with the preparation of many NCSs, which were coordinated by IUCN. There are no estimates of the overall amount of private donor/recipient finance for sustainable development. Rather than regarding NGOs as competitors or ‘environmental police’, governments can benefit by adopting a more positive approach to the contributions of NGOs, such as innovative policy proposals and sustainable development projects.

GOVERNMENT

Government funding of strategies usually entails a reallocation of expenditure from other activities. It is, therefore, necessary to make a good case for government support to a strategy process, particularly in poor countries where government revenue is often constrained by the small size of the tax base and problems of tax evasion. Here, there is a stronger chance of justifying framework activities which eventually might lead to self-financing mechanisms, than there is of projects which require sustained financial inputs.

Frequently, government funding will consist of a commitment of the necessary human resources for strategy and policy formulation and implementation. However, reliance on government funding for strategy formulation involves the risk that the government, and hence ‘ownership’ and priorities, may change in the course of the process. Funding may be cut off before significant progress has been made. This is a problem that can occur even in Northern countries – for example, Canada’s *Projet de société*, which started in November 1992 with money from Environment Canada and other government agencies, suffered a serious setback when the government changed a year later. The new government was concerned to reduce budget deficits and would make no funds available for the process, even though the new environment minister was supportive of the concept (Dalal-Clayton 1996).

Government funding for implementation can be – and will have to be – quite significant. In Chile, the development of an institutional framework for environmental management was financed (originally in 1992) one-third by World Bank sources and two-thirds by Chilean counterparts. When the system started consolidation in 1999, government spending on environmental issues had risen to approximately US\$300 million annually, against a total contribution of donors and bilateral agencies of US\$105 million over a span of eight years (World Bank 2001b).

Governments often channel available donor funds to NGOs. NGOs also need information on private and public donor programmes, the availability of funding and contacts. Such a channelling and information role can be developed by government relatively easily, by using existing or very marginal additional resources. However, governments can go further and work to strengthen social capital which eventually will help in the formulation and the implementation of an NSDS. But this role requires more substantial resources. An NSDS might therefore include a revision of the existing policy and incentives for donations. In many developing countries, donations to environmental or sustainable development objectives have not yet been recognized as eligible for tax credits, which are, in general, applicable to humanitarian aid, education or cultural programmes (Fund of the Americas 2000). The Inter-American Development Bank has recently been involved in several country strategies aimed at strengthening civil society.

OTHER IN-COUNTRY SOURCES OF FINANCE

It is not realistic to expect much direct financial contribution to strategy processes from civil society, except where NGOs are the conduit for donor funds (see previous section). However, in-kind contributions may be considerable as consultation processes involve time input and the provision of information by various stakeholders. But some groups have more financial capability than others, such as large companies and, to a

Government financing of strategies may be justified by efficiency and equity reasons ...

... but a dominance of government funding can produce credibility problems for the strategy

Governments can create incentives to increase voluntary donations for sustainable development

lesser extent, international NGOs. The challenge is to ensure that the less powerful groups are not prevented from participating because of financial constraints.

Private sector organizations – transnational companies in particular – have the most potential to make direct financial contributions for both strategy formulation and implementation. The corollary is the need to ensure that the strategy processes are not compromised in any way. Financing the strategy should not mean ‘buying influence’. Channelling private sector contributions through an independently managed trust fund (see page 296) may be a way of resolving this.

INTERNATIONAL TRANSFER PAYMENTS

These are transfers made by Northern countries to Southern countries in recognition of, or as a payment for, providing global public goods such as biodiversity conservation and carbon sequestration. Transfers are made by multilateral agencies on behalf of contributing countries or by NGOs, or in some cases by the private sector. The three most important types are discussed below.

GEF can fund activities that provide global environmental services and are consistent with local sustainable development needs

Global Environment Facility The GEF was set up to fund projects which protect the global environment in the area of climate change, biodiversity and international waters. Its contribution to projects is based on the ‘agreed incremental cost’ to developing countries of providing global benefits. It also finances enabling activities like biodiversity action plans. While the incremental cost principle sounds simple in theory, it has proved extremely difficult to apply – hence the emphasis on ‘agreed’. The basic approach adopted by the GEF is to distinguish between actions that provide global benefits and those that are in the national interest as defined by a national sustainable development baseline. If there is a gap between the current situation and the national sustainable development baseline, the necessary activities to bridge the gap have to be funded with other sources of finance. GEF will not finance these, as they are not considered incremental.

Partly because of the need to distinguish incremental costs, GEF projects are associated with heavy transaction costs, with projects taking from nine months to four years to prepare. In view of the remit of GEF, projects are focused on environmental benefits, rather than development. While community participation is emphasized in GEF project criteria, it is projects with global environmental benefits rather than community benefits that get funded.

The GEF has recently been moving to further engage the private sector at both project and strategic levels by using ‘contingent finance mechanisms’. These aim to increase the effectiveness of GEF fund use, maintaining the performance incentives for the private investor while reducing investment risks (eg for new technologies or for technologies so far not applied in developing countries). They are expected to leverage other (public or private) capital in high-risk markets. At the same time, these mechanisms reduce the need for direct grants.

The NSDS process may reduce the transaction costs involved in GEF projects because it will provide clarity about the sustainable development baseline. However, by definition, GEF will not be able to finance activities that form a direct part of the strategy, as these will be considered to be in the national developmental interest. The potential contribution of GEF funding to a strategy for sustainable development will, therefore, be primarily through the financing of enabling activities such as biodiversity action plan formulation – the challenge being to ensure that these are consistent with the strategy process. At the implementation stage, GEF funding may have an indirect effect in that it may serve to catalyse other financial support from donors or from the government required as co-funding. GEF contributions to trust funds are also important (see ‘National environmental funds’, page 296).

Carbon offsets and the Clean Development Mechanism² The Clean Development Mechanism of the Kyoto Protocol will allow developed countries to implement projects in developing countries that reduce net greenhouse gas emissions. It has the additional goal of assisting developing countries to achieve sustainable development. Developed countries may use ‘certified emission reductions’ (CER) generated by project activities in developing countries to contribute to compliance with their own emission commitments. A share of the CER will be withheld by the CDM executive to assist developing countries in meeting the costs of adaptation to climate change (see www.unfccc.de/text/issues/mechanisms).

As there are believed to be more opportunities for low-cost greenhouse abatement in developing countries than in developed countries, this mechanism can reduce the cost of meeting commitments and thus provides a powerful incentive for the involvement of the private sector. However, analysts have indicated that, due to an oversupply of carbon credits (in the absence of US participation) and thus low prices, the high transaction costs implied by the CDM may make it an unattractive instrument to some investors (CAEMA 2001). Critics of the CDM have also pointed out that costs may be low in developing countries because of low social and non-climate related environmental standards – rather than because of any difference in carbon abatement efficiency.

After most operational details were confirmed in Marrakech in November 2001, Parties have indicated their willingness to ratify the treaty before the WSSD. This will help to provide more certainty to the private sector regarding the recognition of the Protocol’s mechanisms, especially the CDM. The projects carried out after January 2000 will be eligible for carbon credits under the CDM. Previous ‘carbon offset’ initiatives will have to be regarded as public relations benefits or as learning exercises in preparation for when the CDM comes into force (Landell-Mills et al, forthcoming).

The extent to which the CDM and other similar carbon offset initiatives can promote activities that contribute to sustainable development and promote poverty reduction will depend on how they are implemented. It will, in particular, be determined by the framework put in place to assess projects according to their sustainable development impact and the scope for stakeholder participation in project design and approval (Baumert and Petkova 2000). It is up to the host government to define the sustainable development criteria to which CDM projects must conform. The NSDS can therefore be very important in providing the key reference point for such initiatives. In turn, the actual contribution of these carbon offset initiatives to wider sustainable development will be enhanced if procedures for assessing their sustainable development impact are development through the strategy process. The US\$410 million fund that is being made available as financial assistance to developing countries in the context of the Protocol (see ‘Funding Mechanisms’ in the Marrakech agreement) can help developing countries in this task.

Debt swaps This is a mechanism introduced in the 1980s, by which debt or currency claims against a developing country are cancelled in exchange for environmental or social development commitments (see Box 9.3). Until recently the most common type was debt-for-nature swaps. More recently, the HIPC initiative has linked debt relief with poverty reduction strategies for selected low-income countries.

As a source of finance for an NSDS, debt swaps have two main drawbacks:

- They may not necessarily be additional, as the agencies cancelling or reducing the debt may offset this by reducing other forms of aid.
- They may be unduly focused on developed country priorities. This has been the main criticism of debt-for-nature swaps, particularly where these have concentrated on protected areas rather than sustainable use (eg Panayotou 1994).

An NSDS offers the local sustainable development criteria needed for CDM project design ...

... and also increases the likelihood that CDM projects will actually contribute to sustainable development

Independent local funds for sustainable development can be capitalized by debt swaps ...

² See www.cdmcapacity.org (a joint initiative of IIED, EcoSecurities and Edinburgh Centre for Carbon Management) for more details.

Box 9.3 Examples of debt swaps**Peru**

In 1994, Canada cancelled 75 per cent of the Can\$22.7 million face value of debt owed to it by Peru. In return, the Peruvian Ministry of Economics and Finance paid 25 per cent of the debt amount in local currency to a Poverty Fund, UNICEF and a Nature Fund.

Philippines

A bilateral debt of US\$32.3 million was converted at a 50 per cent redemption rate; that is, half of it was forgiven. In exchange, the Philippines government paid US\$16.1 million in local currency to a private foundation established to finance environmental and social projects.

Jamaica

The Jamaica Environmental Foundation was set up to administer funds from a US government debt swap. These funds are targeted at non-governmental actors' activities that promote local sustainable development policy initiatives.

Principal source: Kaiser and Lambert (1996)

The PRSPs required for debt relief under HIPC have also come in for criticism, as discussed in Chapter 3. But if a way can be found to align the interests of the creditor country with the directions of the strategy, then they may prove useful.

NATIONAL ENVIRONMENTAL FUNDS

In some countries, particularly in Eastern Europe, governments have earmarked revenue from pollution charges and fines for environmental funds. These funds can finance environmental projects through grants and soft loans. These can also operate at regional level (eg in Poland; Zyllicz 1994) and at municipal level (eg in Bulgaria; Klarer et al 1999). Such funds have played a significant role in helping enterprises adjust to stricter environmental requirements and in accelerating environmental improvement. In Poland, these funds accounted for 30–40 per cent of total national pollution abatement and control investment expenditures during 1993–1996 (Klarer et al 1999). Some countries have set up forestry funds, financed by forestry-related charges such as stumpage fees, area taxes and taxes on timber. For example, in Slovenia, the government uses a 10 per cent sales tax on timber to finance a subsidy programme supporting forest management (Landell-Mills and Ford 1999). Both types of fund have the advantage of providing more stable finance for activities such as pollution control and forest management which are typically low on governments' lists of priorities (Landell-Mills 2001).

Such funds could play an important role in the implementation stage of a strategy by providing temporary assistance to companies to help them make the far-reaching changes necessary to move towards sustainability, for example, through giving concessional loans for clean technology.

TRUST FUNDS

Most of the trust funds that are relevant to sustainable development have been set up for environmental purposes, but there are some with social objectives such as poverty reduction. They draw in funds from a number of different sources, typically donor funding but also debt swaps and revenues from environmental taxes or fees (see page 295). For example, the Protected Area Conservation Trust of Belize raises US\$500,000 per year through a tax on tourists entering the country by plane or ship (GEF 1999). But trusts are often created and managed by private organizations or NGOs. For this reason, they are discussed separately here from national environment funds (see 'National environment funds' above) which tend to be created as

... they can be set up by government itself...

... as well as by private organizations

Box 9.4 PROFONANPE – Peru's Conservation Trust Fund

The National Fund for Natural State Protected Areas (PROFONANPE) is a private not-for-profit entity, established in 1992 with the aim of supporting the conservation and management of protected areas. It started with grant finance but, in 1995, received US\$5.2 million from GEF to operate as an endowment fund. By 2000 it had attracted a total of US\$28.8 million from various sources, principally bilateral and multilateral donors and the Macarthur Foundation. It has also received funds from the Peruvian Government as part of debt-swap arrangements. PROFONANPE now plans to broaden its funding base to include more multilateral and regional organizations as well as the private sector. Together with the Nature Conservancy Council, it is currently exploring how to access the debt swap possibilities opened up by the Law on Tropical Forest Conservation approved by the US Congress in July 1998.

The trust fund operates endowment funds, sinking funds and mixed funds as well as earmarked and contingency funds and grant finance.

The board of directors of PROFONANPE includes government representatives from the Ministry of Economy and Finance, as well as the National Institute for Natural Resources and civil society representatives and an international donor representative.

Source: www.profonanpe.org.pe

autonomous government agencies. Typically, trust funds are governed by a board of directors drawn from the private sector, NGOs, government and academia while management of their assets is handed over to professional fund managers. Trust funds are most appropriate when the issues being addressed require financing over a number of years, that is, long-term, stable financing is required. Three types of trust funds are usually distinguished:

- endowment funds, where only income from the fund's capital (ie investment income) is spent;
- sinking funds, which disburse their entire principal and investment income over a fixed period;
- revolving funds, which receive new income from taxes or fees on a regular basis.

In practice, trust funds can involve a combination of these different modalities. Profonanpe, the conservation fund of Peru, has both endowment funds and sinking funds (Box 9.4).

An evaluation conducted by the GEF found that successful environmental funds were the product of broad consultative processes, involved people from different sectors in their governance, and had credible and transparent procedures. It also found that active government support was necessary, even if the fund was operating beyond its direct control (Smith 2000).

In many poor countries, trust funds could provide a mechanism for financing the development and implementation of NSDSs through successive cycles over many years. The Funds of the Americas (see Box 9.5) provide an example of how trust funds can be an important innovative element in NSDSs, especially when they are managed by a multi-stakeholder committee.

Mobilizing finance at the local level

Through decentralization, sub-national authorities (eg districts and municipalities) are increasingly assuming responsibility for sustainable development and are preparing their own development strategies and action plans. However, formal decentralization is seldom backed by adequate financial allocations from the central government (see 'Sub-national strategies', page 63). Local authorities in many developing countries have little or no revenue-raising power and this makes it difficult to formulate and implement credible strategies for sustainable development. Even where they do have such powers, there might not be political will to seek alternatives to dependence on national governments for resources.

Ghana offers an example of one approach to dealing with this problem. Each of Ghana's 110 districts has responsibility to develop and implement medium-term and annual District Development Plans, which

Independent funds offer a long-term, sustainable source of funding – and thus have potential to keep strategy processes alive over many years

Box 9.5 The Funds of the Americas

'Funds of the Americas' were established in four Latin American countries in the 1990s: Argentina, Chile, Colombia and Peru. These Funds were created on the basis of debt swaps between the United States and the countries concerned. They are private-public entities directed at strengthening civil society response to sustainable development. The Funds have developed different sustainability strategies and have made significant contributions to sustainable development in their respective countries.

In Chile, for example, the Americas Fund has financed 198 projects as well as 14 strategic studies that were steered by stakeholder committees and accompanied by communication strategies. Additionally, it has developed three cooperative programmes with private and public sector actors in order to promote sustainable management of the country's natural resources. Between 1995 and 2000, the Fund contributed more than US\$16 million to these projects and initiatives.

Source: www.fidla.cl

Innovative approaches are needed to bring local stakeholders together for mobilizing finance

should address sustainable development. At least 5 per cent of internal government revenue is allocated by parliament to the District Assemblies Common Fund. A formula for distribution between districts is agreed each year based on population and development status indicators. District assemblies are able to use these funds for capital expenditure on development activities (see Box 3.21).

Initiatives that bring the local actors together, while potentially promising for the future financial sustainability of a local sustainable development strategy, do require seed funding to enable trust to be built and a basic institutional framework to be set up. Subsequently contributions from local stakeholders, especially private companies, can be sought. One such attempt is currently being pursued in the Region of Antofagasta, Chile (see www.cipma.cl/bolsambiental/). In Thailand, tax concessions given by the national government were an important incentive for multinational companies to participate in the Thailand Business in Rural Development initiative to promote rural livelihoods (Grieg-Gran 2001).

Using market mechanisms to create incentives for sustainable development

More needs to be learned from where the private sector has adopted sustainable practices spontaneously – learning the lessons of effective policy and market signals that match with producer motivations. (Hanson et al (2000) commenting on the Pakistan National Conservation Strategy)

Market mechanisms can capture funds from users and polluters of environmental resources

Market mechanisms can create powerful incentives to achieve the objectives of the strategy and can have a more lasting effect than mobilizing finance for specific projects. For example, it is pointless to finance a wastewater treatment plant if companies are not charged sufficiently for discharging waste into it. While market mechanisms may generate some revenue, their most important effect is to capture more resources from polluters or resource users or from the beneficiaries of environmental services, and to change their behaviour.³ The use of these mechanisms may thus result in less expenditure on the part of the government and in a more efficient use of resources. However, the distribution of resources is likely to change. The introduction of an industrial pollution emissions charge means that companies have to pay for their use of the assimilative capacity of the environment whereas, previously, they accessed this at no charge. For this reason, finance may be needed in the short term to help certain groups to adjust.

³ The distinction between financial mechanisms and policy instruments to achieve sustainable development can become a little blurred. The emphasis here is on policy measures that can be classified as financial.

A number of reports have addressed the issue of financing mechanisms for sustainable development: for example, Panayotou (1994) on Agenda 21, and Landell Mills (2000) and Richards (1999) on sustainable forest management. The literature on market mechanisms for sustainable development is extensive. In the *Five Years after Rio* report by the World Bank (1997), a policy matrix describes different market mechanisms and provides concrete examples of their implementation. In recent years, several initiatives have addressed how market mechanisms can be adequately implemented in the face of very slow adoption, especially in developing country contexts. One ongoing initiative is UNEP's Expert Group on the Introduction of Economic Instruments, run by its Economics and Trade Unit. Market mechanisms can operate at the national level (see next section) and, to a lesser extent, at the local level (page 302).

Market mechanisms at the national level

There are three basic approaches:

- Remove existing financial mechanisms that work against sustainable development, such as energy subsidies.
- Adapt existing market mechanisms.
- Introduce new financial mechanisms that internalize environmental or social externalities.

The three types of measure will have winners and losers and their impact and effectiveness will vary depending on the nature of the sector, or the environmental or social issue being addressed. For this reason, a study of their potential impact is needed first – as discussed on page 291.

REMOVING PERVERSE INCENTIVES

For a number of reasons, key productive inputs such as energy, water and pesticides are often priced below private marginal cost. This may be because of government subsidies or price controls which aim to encourage industrial productive activity. Alternatively, the rationale may be to protect the interests of low-income groups or to provide services considered to have public health benefits. In some cases, it may be considered administratively simpler to have less precise charging policies. WRI (1996) estimated that, on average in developing countries, consumers pay only 35 per cent of the costs of water provision. This underpricing results not only in economic losses but also in environmental costs, because it encourages activities which use natural resources or degrade the environment. For example, in the case of Poland, it was estimated that the removal of energy subsidies would have reduced emissions of particulates and sulphur oxides by more than 30 per cent between 1989 and 1995 (World Bank 1992).

As Panayotou (1994) notes, the removal of distorting subsidies has a number of positive effects. It frees up financial resources which can then be deployed in activities more conducive to sustainable development. It improves the environment. It encourages economic efficiency. And it is likely to improve income distribution. The OECD (1998), drawing from case studies in several member countries, has shown how the removal of subsidies in agriculture, energy, industrial activities and transport can lead to win-win situations.

Even where subsidies have the aim of protecting the interests of the poor or providing public health benefits (eg free or subsidized water supply), they may be counter-productive for sustainable development objectives. Many of the problems in providing water and sanitation stem from inadequate cost recovery. At the same time, it is the poor that are least likely to be connected to subsidized municipal water supply and sanitation systems (Johnstone 1997). Instead of providing poor quality urban services at subsidized rates, it would be better to charge the full rate for a service that is more reliable and more tailored to the needs of low-income communities (Panayotou 1994). Involving communities in the provision of such services may

Removing subsidies for energy and resource use can benefit sustainable development ...

... including for the poor

Box 9.6 Integrating sustainable development objectives into the tax system – Belgium

Belgium has prioritized the mainstreaming of sustainable development principles into the fiscal system in its Federal Plan for Sustainable Development 2000–2004. It aims to review the tax base, abolish preferential fiscal regimes for products and production processes which pollute, introduce a (supplementary) tax on patterns of production or consumption which are undesirable for social or ecological reasons, and/or introduce preferential regimes for desirable ones.

An interdepartmental working group, chaired by the Ministry of Finance, will prepare a report on the green reform of taxation. The group will first draw up an inventory of all the exemptions and reductions which exist within the fiscal system and which militate against sustainable development, and then formulate proposals to amend this situation. It will also look at various proposals for green taxes.

Source: Federal Plan for Sustainable Development 2000–2004, Belgium

also reduce the overall financing needs. In the context of development projects in Pakistan, it has been estimated that a service that costs US\$1 when delivered by the local community, costs between \$3 and \$5 when it forms part of a government project and between \$7 and \$30 if it is a component of a World Bank-funded project (Hassan 2001).

Identifying and addressing such perverse incentives requires the participation of the Ministry of Finance or equivalent authority as well as other line departments since it may involve a radical rethinking of standard tax policy – as the case of Belgium shows (Box 9.6).

ADAPTING EXISTING MARKET MECHANISMS

In order to create an incentive for sustainable development, it is often a better to adapt existing policies so that they more adequately take account of sustainable development objectives, rather than remove them or introduce new mechanisms. A study of adaptable existing instruments in Chile called them ‘pseudo economic instruments for environmental policy-making’ (ECLAC 2001), emphasizing that, while the instruments appear to be market mechanisms for environmental policy-making, they were, in fact, originally designed on purely economic grounds. The study provides examples of such instruments, including:

- A subsidy for reforestation activities which originally included exotic as well as native species. This is now being redirected at native species and small- and medium-sized owners only, taking account of environmental and social considerations.
- A system in which the rights to use water have been allocated free of charge, with no restrictions concerning hoarding of the rights.

An important point is that adaptations of existing market mechanisms are relatively easy to implement and no new administrative system is required to introduce them. So they might be perceived as a more viable option than introducing entirely new mechanisms.

NEW MARKET MECHANISMS

Market mechanisms may penalize companies or individuals for adverse environmental or social impacts. Or they may make them pay for natural resource use. Or they may reward them for providing environmental or social services. These approaches have three main advantages:

- They can reduce the costs of achieving the objectives set out in the strategy for sustainable development.

Many existing market mechanisms have potential for sustainable development – if they can be ‘retuned’ towards sustainable outcomes

New market mechanisms can be designed to produce multiple benefits for sustainable development ...

- They provide continuing incentives for innovation and improvement.
- They provide a source of revenue which can be used for the purposes of the sustainable development strategy – whether through earmarked funding of specific activities, a contribution to an environmental or social fund, or offsetting other taxation (eg on labour). In Eastern Europe, environmental funds created from the various environmental charges introduced are playing a key role in the move to address environmental problems.

There is now experience of a wide range of mechanisms which have been introduced in both developed and developing countries, from which considerable lessons can be drawn (see Box 9.7).

Box 9.7 Market mechanisms for meeting sustainable development objectives

- Emission charges such as effluent charges, and SO₂ and NO_x taxes – to encourage firms to reduce their emissions through process-integrated and end-of-pipe measures in order to avoid charge payments.
- Waste taxes (eg landfill tax) to make final waste disposal more expensive and so promote recycling and waste reduction.
- Product taxes on, for example, energy, lubricant oils, batteries, fertilizers, pesticides and packaging, and other products which have an environmental impact in manufacture, consumption or disposal.
- Tax differentiation to favour sustainability (eg leaded and unleaded petrol) to divert consumption away from a more polluting product to a less polluting product.
- User charges such as entrance fees for natural parks.
- Subsidies or preferential credits for the introduction of clean technology or other production that implies the provision of positive environmental externalities.
- Increased resource rent capture (eg for forest concessions) through competitive bidding and area-based taxes, and for water through abstraction charges (eg groundwater pricing in Thailand).
- Environmental performance bonds in mining and forestry to ensure that abandoned mine sites are reclaimed and that reforestation or sustainable forest management is carried out.
- Deposit refund schemes (eg on packaging) to encourage reuse, recycling or controlled disposal. A deposit is made on purchase of a product and refunded when the product or, in some cases its packaging, is returned to a designated point.
- Markets for environmental services: for example, tradable permits for SO₂, carbon offset trading, transferable development rights, payments for watershed protection (see Table 2.1).

The main issues associated with such mechanisms are:

- *Determining the appropriate level of the charge or payment.* Early schemes were introduced more as revenue-raising instruments than behaviour-changing approaches. Charges were therefore low. Later schemes have tried to put more emphasis on the incentive effect.
- *Enforcing payment and dealing with evasion* without increasing unduly the administrative costs involved, especially where there is poor regulatory enforcement. Mexico's wastewater charge has suffered from poor enforcement (Seroa et al 2000).
- *Overcoming resistance from certain groups* who are likely to lose as a result of the introduction of the market mechanism. Fossil fuel energy taxes have been resisted by energy-intensive industry sectors with the result that they have often been watered down by the inclusion of exemptions and reductions. International cooperation can help to overcome these problems. For example, at the meeting of the UN Preparatory Committee for the International Conference on Financing for Development in October 2001, the introduction of a carbon tax on an international scale was considered as one of the principal mechanisms by which sustainable development could be promoted. While industrialized nations would have to contribute a certain proportion of the tax to

... but there are several constraints to their effective operation ...

the international agency in charge of the administration, developing countries would be exempted from such obligation and could thus earmark the total amount to sustainable development strategies.

- *Dealing with regressive impacts on the poor* who are least capable of adapting to the proposed changes. Taxes on fossil fuels, for example, may have adverse impacts on the poor unless assistance can be given to these groups to adopt energy saving measures; for example, upgrading cooking and heating equipment to new, more efficient means.
- *Ensuring that the revenue raised is used appropriately*, and to provide safeguards against misappropriation. This will usually involve setting up institutional structures.

The OECD (1997b, 2001) has evaluated market mechanisms in OECD countries. The Economic Commission of Latin American and the Caribbean has recently compiled first evaluations of these mechanisms for that region (ECLAC 2001).

Some financial mechanisms shift the cost of controlling or monitoring from the state to companies. But such approaches are often left out of the overall 'menu' of market mechanisms because they lack the incentive element of the traditional market mechanisms. However, in a developing country context, they can be important instruments to finance environmental policy tools. In Peru, the cost of monitoring the environmental plans of mining companies is met by the companies concerned (CONAM 1998).

... which the strategy process can help to overcome

Market mechanisms at the local level

The extent to which the mechanisms described above can be applied by local governments depends on the extent of decentralization and the associated division of responsibility and authority. In many cases, local governments have limited tax-setting authority. But they may often have control over the provision of urban services such as waste collection, water supply and sanitation. Greater cost-recovery for services controlled at the local level will both mobilize finance and increase the efficiency of natural resource use. Brazil provides an example of a financial mechanism operating at local level to meet environmental and social objectives (Box 9.8).

Box 9.8 Financial mechanisms for environmental objectives at the local level: the ICMS Ecologico

The ICMS ecologico shows how the rules on revenue-sharing between different levels of government can affect incentives for sustainable development at the local level. The ICMS is a sales tax levied by the various states of Brazil. Under the Brazilian constitution, state governments must pass on 25 per cent of the ICMS revenue to municipalities. Of this amount, 75 per cent is distributed between municipalities on the basis of the value added they generate. The remaining 25 per cent is divided between municipalities according to criteria chosen by the state government. Traditionally, these criteria have been population, land area and agricultural production. But in some states of Brazil, an ecological criterion has been introduced. This is based on the area of land subject to protection and, in some cases, the quality of protection. This provides an incentive to municipalities to designate protected areas and to improve the management of existing ones. In the State of Parana, 2.5 per cent of the total amount passed on to municipalities is distributed according to this ecological criterion. Another 2.5 per cent is distributed on the basis of watershed protection areas. In Minas Gerais, in addition to the ecological criterion, distribution is also on the basis of the quality of urban services, sanitation and waste disposal.

Source: Grieg-Gran (2000)

Mainstreaming sustainable development into investment and financial decision-making

The success and credibility of a strategy for sustainable development depends on the extent to which key stakeholders act in accordance with it. For example, a strategy that emphasizes the promotion of renewable energy or energy efficiency is undermined if investments are made by private sector or public sector organizations in fossil fuel power plants. This means that key financial decisions have to be coherent with the NSDS, and that at the same time, the integration of sustainable development objectives into companies' decision-making should be one of the key objectives of the NSDS. To achieve this, a number of different actors must be involved, notably: government departments, the private sector and financial institutions both in-country and overseas (see Box 9.9). Given the importance of foreign investment in developing countries, the situation is complicated by the need to address foreign-owned companies and the financial institutions that support them. Most corporate decisions on foreign direct investment (FDI) involve the participation of a financial institution – either directly through the provision of a loan to cover establishment costs, or indirectly through, for example, the provision of risk insurance. Local financial institutions, which in developing countries are increasingly foreign-owned, are also important sources of finance for productive enterprise.

To develop a coherent NSDS with the right tools, it is important to understand the motives for companies and financial institutions to address sustainable development. A key requirement is to improve the disclosure by companies and public and private financial institutions of their investment decisions – a necessary condition for channelling private resources towards sustainable investments and for monitoring the impact of their activities.

Motives for addressing sustainable development

For all the different types of institution listed in Box 9.9, a key question is: why should they be interested in making sustainable development a core consideration for their operations?

Multilateral and bilateral development finance institutions (DFIs) and export credit agencies (ECAs) have been criticized by NGOs for the apparent conflict between their financing decisions and their respective government's policy on aid and sustainable development (or international development goals in the case of the multilateral institutions). The prime objective of the ECAs is to promote industrial development or exports of the source country. But a significant driver is the need for coherence with overall government policy. So, until recently, they have paid little attention to the impacts on the host country of the developments they fund. But pressure from NGOs is now forcing them to look at the wider impacts of their activities. This comes after some controversial projects involving ECA funding, such as the Three Gorges Dam in China and the Illisu Dam in Turkey. In late 2000, the UK Export Credit Guarantee Department published a statement of business principles. The aim was to ensure that its activities reflected the government's policies on sustainable development: environment, human rights, good governance and trade (see www.ecgd.gov.uk). ECAs in other OECD countries are developing similar policies, and the OECD is now developing guidelines for ECAs to ensure a level playing field for companies.

For the government institutions of the host country, the coherence argument is less compelling. Pressures to compete with other countries for inward investment could lead to acceptance of FDI activities which conflict with an NSDS in terms of environmental or social standards. The provision of incentives or tax concessions may also undermine financial mechanisms to drive sustainable development introduced in the strategy. Two factors may encourage this lack of interest in coherence: institutional pressure to meet certain objectives (eg the number and size of inward investment deals, or number of jobs created); and the perception that addressing sustainable development will be a net cost.

Investors should include local sustainable development criteria in their decision-making

Assessing investor motivations and the investment criteria they currently use is a useful strategy task

Box 9.9 Types of institution involved in private sector investment decisions in developing countries**Official agencies***Domestic*

- Ministry of Industry or Finance and other ministries involved in negotiating with foreign investors.
- Investment Promotion Agency, or Board of Investment – at national and sub-national levels – is charged with publicizing investment opportunities in the country and attracting foreign investors.
- National development banks provide loans and equity finance for local enterprise.

Multilateral/bilateral development finance institutions

Development finance institutions (eg IFC and Swedfund) aim to promote private sector expansion in developing countries by providing loan or equity finance as well as catalysing private capital. They also invest in venture capital funds to provide start-up finance for companies.

Export credit agencies

Export credit agencies (ECAs) were originally set up to promote trade by providing government-backed cover to companies for the risks involved in exporting or by assisting buyers with finance. Nowadays, the functions of ECAs are much broader and extend to investment guarantees, political risk insurance and, in some cases, direct finance for investment through loans and equity funds. Thus, ECAs are an important player in foreign direct investment decisions, particularly regarding large infrastructure, mining and oil and gas projects. Their participation may determine whether or not a project goes ahead.

Private sector*Asset managers*

Institutions that manage pension funds and mutual funds in developed countries are important investors in many transnational companies and/or companies with supply chains in developing countries. They also invest directly, but to a lesser extent, in publicly traded developing country enterprises. In some middle-income countries, local pension funds are becoming important investors.

Commercial banks support foreign direct investment and local enterprise through the corporate and project finance they provide for new facilities, expansion or company acquisition.

Private equity/venture capital is often invested in companies that are not listed on stock exchanges, and typically invested in high return, high risk activities. Such investment is particularly important for financing start-ups and restructuring of companies.

However, it has been observed that those governments which are most successful in attracting FDI are also those that meet the requirements for good governance. So, instead of using a traditional incentives approach, a rules-based approach – concentrating on the creation of more stable and transparent rules for investors – could be effective as a means of attracting FDI without necessarily weakening environmental and labour standards (Oman 2000). In order to convince those government institutions concerned with investment of the need to address sustainable development, it will be necessary for the NSDS process to address the rules governing investment.

For private sector institutions, the most effective argument is that there is a business case for addressing sustainable development issues. This is illustrated by the findings of a UNEP survey of financial institutions, which found that a significant obstacle to integrating environmental issues into credit and investment analysis was a perception that such issues are not important for profitability (UNEP/PWC 1998). However, this business case argument is also being promoted for public sector institutions, especially because of the pressures for them to operate on a commercial basis.

The business case for sustainable development can be addressed at two levels: at the company level and at the level of the supporting financial institution.

COMPANY LEVEL

It is widely claimed that companies practising corporate social responsibility have a number of financial benefits which ultimately affect the returns and risks for investors. Typical arguments include:

- *Cost savings*: Clean technologies are usually more efficient, while reducing raw materials use and increasing recycling can reduce production costs. Similarly, good working conditions can lead to higher productivity and fewer union disputes and make it easier to attract and retain employees.
- *Greater readiness*: Changes in legislation (eg tightening regulations) or changes in rules on liability for damage can imply significant costs – these are sometimes unanticipated for companies. Companies that can prepare for regulatory change, through, for example, voluntary action, will have a competitive advantage.
- *Market benefits*: Companies that can demonstrate compliance with stringent environmental and social standards can generate market benefits. They can access certain environmentally sensitive markets, or are more likely to retain their existing markets if buyers adopt stricter purchasing standards, or they may secure higher prices for their products.
- *Reputation and risk management*: Responsible business practice has a positive impact on the reputation and public perception of the company. Loss of reputation can affect sales, particularly where NGO campaigns are urging consumer boycotts. More generally, it can affect the company's social 'licence to operate'. Safeguarding reputation is important for maintaining good relationships with regulators and the local community. This has financial benefits in reducing the time required to secure government approval of, and community support for, new developments or expansion.

The business case for sustainable development needs to be explored through the strategy process, both from the company point of view ...

THE BUSINESS CASE FROM THE FINANCIAL INSTITUTION VIEWPOINT

The financial benefits to companies from addressing sustainable development issues translate into higher returns or lower risks for investors. Conversely, the increased risk facing a company from inadequate management of the environmental and social aspects of its operation can turn into risks for the supporting financial institutions.

Risk assessment is a standard part of procedure for investment decisions, but it is only recently that environmental and social issues have been considered an essential part of risk. Environmental and social risk for financial institutions can be classified as:

- *Direct risk* – where the financial institution finds itself liable for clean-up costs or third-party claims for pollution damages. This may occur where a bank forecloses on a loan and takes possession of land offered as collateral.
- *Indirect risk* – where tightening environmental regulation affects a company's cash flow and ability to repay loans or generate a return on investment.
- *Reputation risk* – where failure on the financial institution's part to give careful consideration to environmental and social impacts of a project can result in bad publicity for both the institution and the company concerned.⁴

More positively, the way a company deals with sustainability issues may provide a good indication of its management capability, which is one of the most important factors in any financial decision. Effectiveness

... and from the investor's point of view

⁴ Based on UNEP Financial Institutions Initiative Fact Sheet No. 3 'The Environment and Credit Risk' (www.unep/ch/etu/finserv/finserv/Fact-Sheet-3.htm).

in dealing with complex sustainable development challenges implies an ability to handle other management areas as well (Trevet 2000).

CRUCIAL FACTORS IN THE BUSINESS CASE

The business case argument relies heavily on the following factors:

- Governments introduce and enforce regulation on environmental and social issues.
- Markets become sensitive to sustainable development issues.
- The threat to company reputation of poor environmental and social performance, if publicized, will have an impact on the financial performance of the company.

In many developing countries, the first two factors are currently less relevant, as enforcement of legislation is weak and consumers are not so interested in issues beyond price and quality. So here the immediate argument hinges on the financial implications of impacts on company reputation at local, national and international level. Yet reputation risk is uneven in its impact, and is likely to affect large companies with high consumer visibility more than others.

The NSDS process may not necessarily make companies more visible. However, it may provide a more objective basis for judging the reputation of a company. The process can raise awareness about societal expectations of companies, and about what trade-offs between economic development and environmental and social performance are considered acceptable. Business participation in the NSDS process could also have a positive impact on reputation, both for companies and for the financial institutions that support them.

How can financial institutions mainstream sustainable development?

With some exceptions, financial institutions have traditionally approached decision-making in a narrow way, without giving much attention to environmental or social impacts. However, there are signs of change as many institutions (albeit mostly in the North) are introducing procedures for environmental and social assessment. A large number of institutions have endorsed the UNEP Statement by Financial Institutions on the Environment and Sustainable Development (see Box 9.10). In addition, some large transnational financial institutions have signed up to the Global Compact (see page 17), implying a commitment to social and environmental sustainability.

CHALLENGES FOR NORTHERN FINANCIAL INSTITUTIONS

The challenge for Northern financial institutions is to determine what standards are appropriate as a reference point, and to ensure that these take account of local perspectives and priorities. This is particularly important where host country legislation does not set or effectively enforce high environmental and social standards. There is some pressure from Northern NGOs on official financing agencies to exclude certain activities altogether (eg mining and fossil fuels) because of their environmental and social impact. But these sorts of decisions need to be made at the country or local level on the basis of an analysis of the trade-offs as in the NSDS process.

Another challenge for financial institutions is to examine impacts beyond project and company boundaries along the supply chain. Given the complexity of the network of suppliers and contractors that can be associated with a particular company, and the lack of transparency that has typically prevailed in such trading relationships, collecting the information needed for assessment can be difficult.

A number of mechanisms have been developed which can help companies and financial institutions to address environmental and social issues when evaluating investment decisions:

The NSDS can guide foreign investors on the sustainability standards that make sense locally

Box 9.10 UNEP Financial Institutions Initiative

A wide range of institutions have signed up to the UNEP Financial Institutions Initiatives (commercial banks, investment banks, venture capitalists, asset managers and multilateral development banks). They have endorsed the UNEP Statement by Financial Institutions on the Environment and Sustainable Development. This commits signatories to incorporate environmentally sound practices into their operations. A secondary objective of the Initiative is to foster private sector investment in environmentally sound technologies and services. In spite of the inclusion of 'sustainable development' in the UNEP statement, the emphasis is mainly on environmental issues, reflecting the remit of the driving organization.

So far, signatories have been primarily from Europe and North America. However, UNEP has been holding meetings in different regions to encourage financial institutions in developing countries to sign up (starting with Asia in April 2001 and Latin America in November 2001). Examples of signatories include: Philippines Land Bank, Uganda Commercial Bank, Banco Nacional de Angola and Thai Investment and Securities Public Company. In developing countries, signatories are mainly development banks and other government-owned institutions, but participation of the private sector is being promoted through the regional meetings. However, some of the largest transnational private financial institutions are also represented: HSBC, Barclays, UBS and Citigroup. These institutions are increasingly setting up affiliate companies in developing countries.

A survey was carried out in 1998 to monitor progress of the signatories to integrate environmental considerations. It found that the majority of responding organizations had an internal environmental policy and a dedicated environmental department, and had in operation, or under development, environmental policies and procedures for corporate credit and project finance. Fewer institutions had environmental policies covering investment banking or insurance.

The environmental issues most commonly considered in credit, investment and insurance transactions were:

- legal compliance;
- overall company reputation;
- the nature and extent of environmental liabilities.

Source: UNEP/PWC 1998 www.unepfi.net

- *Certification schemes* can reduce the extent of information gathering and assessment required of individual investors by offering an independent seal of approval or assessment of key environmental and/or social performance.
- *Improving the quality of company reporting on sustainability issues*, facilitating interpretation by investors and comparison with other companies. The Global Reporting Initiative (GRI) aims to standardize sustainability reporting and put it on a par with financial reporting in terms of credibility and comparability. Sustainability reporting guidelines were launched by GRI in June 2000 following multi-stakeholder discussion, and are currently being revised.
- Following the model of credit ratings and stock market indices, a number of organizations have developed *environmental and/or sustainability ratings* for companies. Given the problems of environmental and sustainability reporting mentioned above, these organizations aim to use expert analysis to interpret and assess this information and assign a rating to each company in a sector (Box 9.11).

It is unrealistic to expect that the overseas financial institutions will play a major direct role in the NSDS process. Nevertheless, it is important to consider how the strategy process can reinforce their initiatives by providing reference standards, generating information and securing stakeholder agreement on activities/sectors to be prioritized and those to be avoided.

CHALLENGES FOR NATIONAL FINANCE AND INVESTMENT INSTITUTIONS

All the national level institutions listed in Box 9.9 need to be involved in the strategy process. Government agencies concerned with inward investment and industrial development generally must broaden their remit

Box 9.11 Sustainability ratings for companies

The Dow Jones Sustainability Group Index (DJSI) tracks the performance of the leading sustainability-driven companies in the Dow Jones Group Index. It aims to provide investors and industry with a neutral, rigorous and transparent measurement of sustainability performance. As of October 2001, the two component Indexes, the Dow Jones Sustainability Index World and the Dow Jones STOXX Sustainability Index, included 300 and 151 companies from 64 industries respectively. The DJSI World selects the top 10 per cent of the leading sustainability companies in the Dow Jones Group Index. The DJSTOXX Sustainability Index includes the top 20 per cent of the Dow Jones STOXX600 index in terms of sustainability. Companies are assessed according to a methodology devised by DJSI, which assesses economic, environmental and social risks and opportunities. The criteria include general as well as industry-specific issues. Social criteria addressed include: strategies for stakeholder involvement, formulation of a social policy, corporate codes of conduct and standards for suppliers. The basis for the assessment is information supplied by the company through a questionnaire and company policies and reports as well as publicly available information (see: www.sustainability-index.com).

The FTSE4Good index series is a similar approach from the other main market player in stock market indices (see www.ftse4good.com). It was launched in 2001. The series consists of eight regionally different indices for socially responsible investment. Companies must apply for consideration and are assessed according to environmental sustainability, social issues and stakeholder relations, as well as human rights.

The NSDS process offers an opportunity for national finance institutions to address sustainable development costs, benefits and risk – and to work together on forging coherent standards

to address sustainable development issues. Financial institutions need to be persuaded of the benefits of integrating sustainable development considerations into their operations. Both types of institution must therefore be key stakeholders and participants in the NSDS process from the outset.

In developing the strategy, it is necessary to identify activities which will build capacity within financial institutions for assessing sustainable development, to generate information and agree on reference standards. This may involve new initiatives but, in some cases, it may be possible to build on or link in to existing initiatives. Box 9.12 provides examples of national and regional initiatives in developing countries which aim to provide information for investors on company environmental and social performance, and to raise awareness about the links between financial performance and sustainable development.

Box 9.12 Examples of sustainable investment initiatives in developing countries**Brazil**

The Eco-financas initiative in Brazil was launched in September 2000 as a partnership between Friends of the Earth and a São Paulo business school. It aims to educate NGOs about financial institutions and raise awareness in financial institutions about environmental issues. Workshops are organized for NGOs on finance, and for financial institutions on environmental issues – notably environmental risk and environmental management systems.

Asia Pacific

The Association for Sustainable and Responsible Investment (ASRIA) was formed in 2000 to promote corporate responsibility and sustainable investment practice in the Asia Pacific region. It aims to create a community of individuals and organizations interested in sustainable and responsible investment (SRI) and, in so doing, to mobilize the capital markets in Asia so that they reward sustainable enterprise. Its basic premise is that the 'triple bottom line' approach of integrating concerns such as social justice, economic development and a healthy environment with financial considerations can bring both financial and societal benefits. ASRIA is supported by some of the key financial players in the SRI field in Europe and North America (see www.asria.org).

India

The Centre for Science and Environment in India is implementing a 'green ratings' project. It aims to analyse the relative performance of Indian industries in incorporating good environmental management principles in their management practices. The ratings are intended to provide information for investors, but will also be useful to industrial managers and regulatory agencies. Ratings have been produced for the pulp and paper sector and are under preparation for the automobile and chlor-alkali sector (see www.oneworld.org/cse/html/eyou/eyou32_old.htm).