Environmental Finance

Financing Water and Environment Infrastructure: The Case of Eastern Europe, the Caucasus and Central Asia

Summary in English

Executive Summary

The countries of Eastern Europe, Caucasus, and Central Asia (EECCA) face substantial environmental challenges. Although the nature of those challenges is diverse, many are similar, due to parallel development during the past decades. The common problems are mostly related to the persistence of inefficient production structures, out-dated technologies, ineffective environmental policies and institutions, and to a relatively extensive, but deteriorated and expensive-to-operate, environmental infrastructure. Thus, some of the common challenges include:

- The magnitude of costs for achieving (usually unrealistic) environmental objectives far exceeds the resources available for relatively small markets.
- The population has a better access to services than inhabitants of countries of the same level of income, though the quality of these services is usually poor and deteriorating;
- Enterprises generally lack the incentives and means to improve their environmental performance.

Environmental finance in EECCA. Situation and prospects

Data on environmental expenditure indicate the financial resources allocated to environmental policy objectives. The EAP Task Force has supported EECCA countries in collecting this data as a necessary first step in improving the efficiency and effectiveness with which they are used.

Some features of environmental expenditures in EECCA countries are:

- In some EECCA countries, environmental expenditure, as a share of GDP, is higher than is expected; Moldova is a clear example, where this ratio reaches 3.1% (compare with a range of 0.6 to 2.8% in OECD countries); however, in other countries(Armenia, Azerbaijan, the Kyrgyz Republic, Turkmenistan) the ratio is lower than OECD average;
- The lion's share usually goes to the water supply and sanitation sector (50-85% of total expenditure), mostly on operation expenditure. However, this is not sufficient to arrest the deterioration of services. The consequences of inaction would be severe, so this sector, and environmentally-related infrastructure, are given particular emphasis in this report;
- Environmentally-related investment remains at a low level, as part of Gross Fixed Capital Formation (GFCF, less than 3%);
- The small size of the markets in absolute terms in most EECCA (from 12 to 49 million USD a year per country, except for Russia, Ukraine and Kazakhstan) represents obstacles to the development of innovative technologies and financial products.

Foreign environmental official development assistance (ODA) provides some additional support. Although ODA flows have increased, they generally remain at relatively low levels compared to other regions, suggesting that there may be opportunities to channel additional foreign resources to the environment (among others). However,

- to increase the level of environmentally-related ODA would require EECCA countries to prioritise environmental issues in national development strategies and in international cooperation programmes;
- the impact of foreign direct investment (FDI) in the environment sector, and in related industries (in particular, the energy sector) could be strengthened, once a clear and stable environmental and institutional framework is set up;
- innovative financial approaches are still to be developed and implemented in the region; this requires identifying new opportunities in the changing context of development finance, e.g. negotiating debt-for-environment swaps as part of broader debt restructuring packages.

The limited role of foreign assistance confirms that domestic sources will have to provide the bulk of total finance for the environment. The private financial sector is developing. It has still to learn how to be associated with public funds, to increase the leverage of public environmental expenditure.

Consequences for policy making

The two main challenges of environmental finance in EECCA countries are, first to make the best use of existing resources, and second to channel more domestic and foreign money into environmental issues. The report makes nine main recommendations to this end:

1. *Improve the data and information base for effective environmental financing*. In order to address critical financing bottlenecks, and to allocate scarce public funds where they are most needed, EECCA countries should improve their systems for monitoring environmental expenditures, by introducing internationally-recognized methodologies, such as those used by Eurostat and OECD.

2. *Use public financial resources for environmental purposes more efficiently*. EECCA countries should use scarce public financial resources available for environmental purposes with greater efficiency, transparency and accountability. Public agencies managing environmental expenditure in EECCA countries might improve their ability to attract government resources, domestic private, and foreign finance, if they operate according to acknowledged standards of good governance and sound public finance. Good Practices of Public Environmental Expenditure Management, developed by the OECD/EAP Task Force, could help reform institutions that manage public environmental expenditures, including Environmental Funds.

3. *Reform the system of environmental charges* and clarify their revenue raising and/or incentive function for environmental protection. The report identifies measures that could be taken to strengthen the revenue-raising function of pollution charges. Most importantly for revenue-raising purposes, charges need to be significantly increased and focused on fewer pollutants. Experience from OECD countries suggests, for example, that taxes on products rather than on emissions yield higher and more predictable revenue. Fiscal instruments to capture rents (excess profits) that private agents earn on exploiting natural resources could be important for some countries.

4. *Develop high-quality and realistic environmental programs and financial plans*. Realistic finance strategies should be developed to support the achievement of the objectives of environmental programmes. To this end, the use of methodologies such as FEASIBLE should be applied more broadly and deeply in EECCA countries. Ability and willingness to pay for environmental improvements need to be explicitly addressed. Project owners, in particular municipalities, municipal service providers (such as water utilities), and small and medium size enterprises require targeted training in financial planning and project preparation.

5. *Strengthen municipal finance and financial sustainability of environmentally-related utilities*. Central governments should establish frameworks for municipal finance that provide municipalities with incentives and means to mobilize finance, in a fiscally responsible manner, for investment in environmentally-related infrastructure. Further efforts are needed in most EECCA countries to promote decentralization and to improve fiscal relations between sovereign and sub-sovereign levels of government. Municipalities should strengthen their financial management and capital budgeting, e.g. through preparation and implementation of multiyear investment plans for municipal infrastructure and related programs. This would enhance their creditworthiness, thus increasing the capacity of municipalities to implement and finance investments. In the same vein, improving the managerial, financial and operational autonomy of local service providers is an essential condition of sustainability of local environmentally-related services.

6. *Promote better access to capital and financial markets for financing investments in environmentally-related infrastructure*. As part of the process of fiscal decentralization, the policy and institutional obstacles that prevent the financial sector from playing a greater role in financing environmental projects should be removed; incentives for such an involvement include the right for local authorities to incur debt,

support to the development of carriers of long-term savings (insurance companies, banks), regulation on the portfolio of these institutions (and the share that they are allowed to invest into local jurisdictions), etc. Experience from other regions could be applied in EECCA countries to enable local capital and financial markets to play a greater role in financing environmentally-related infrastructure.

7. *Utilize opportunities for debt-for-environment swaps as part of debt restructuring.* Debt-for-environment swaps reduce a portion of external debt in exchange for the debtor country spending an agreed portion of the reduced debt on domestic environmental improvements in local currency. However, they can also affect the country's credit rating and increase costs of sovereign borrowing. Hence, swaps are best considered in conjunction with wider debt-restructuring or debt relief scheme. So far, Georgia and the Kyrgyz Republic have used the opportunity to include a swap clause in the framework agreement with a group of official creditors.

8. *Access resources made available via carbon funding*. The recent development of carbon funding generates new opportunities for Annex 1 and Annex 2 countries to channel international finance for environmentally related projects. CDM mechanisms require that these countries elaborate portfolios of projects which qualify to receive funding from partners in Annex 1 countries. As such portfolios develop, there is a need to finance the treasury gap that exists between the initial investment and the moment the project generates stable revenues from CDM mechanisms.

9. *Assign higher priority to environment in national development strategies and in international co-operation.* EECCA countries should assign a higher priority in international cooperation. Failure to do so may mean that environmentally-related bilateral assistance remains low compared to other regions of the world, and disbursement of IFI loans small compared to efforts and resources spent on project preparation. Environment should also be more effectively integrated into national development strategies, including the Poverty Reduction Strategy Papers. In the terms of references for cooperation projects, more emphasis could be put on building local capacity of experts and consultants to provide policy advice and technical assistance according to international standards.

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