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Conference on Environment and Development

Report of the Secretary-General

Addendum

Financial resources and mechanisms*

(Chapter 33 of Agenda 21)

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INTRODUCTION

1. The present report reviews progress made in the implementation of the objectives set out in chapter 33 of Agenda 21 (Financial resources and mechanisms),^{1/} taking into account the decisions taken by the Commission on Sustainable Development on that subject in 1993, 1994, 1995 and 1996, at its first, second, third and fourth sessions. Chapter 33 of Agenda 21 provides an agreed framework for the financing of sustainable development, and is related to the implementation of all other chapters of Agenda 21.

2. Agenda 21 acknowledges that, in general, the financing for its implementation will come from a country's own public and private sectors. However, it clearly places the financing of sustainable development within the global economic context by stating that developing countries will need substantial new and additional funds for the implementation of sustainable development programmes, and that official development assistance (ODA) should be a main source of external funding for those countries, especially the least developed countries.

3. Interestingly, the most important source of external finance for developing countries since the United Nations Conference on Environment and Development (UNCED) has been private capital flows, particularly for Latin American and Asian countries that have embraced outward-looking strategies and sound macroeconomic policies. Nevertheless, the conclusions and recommendations of international experts have regularly emphasized that while private flows are a necessary condition for sustainable development they are not sufficient, because first, most of the poorest countries do not obtain substantial amounts of private capital, and second, sustainable development requires some types of social and environmental investments that do not attract private capital.

4. There have been three main developments concerning the flow of public resources to developing countries since UNCED: first, a decrease of ODA in both absolute terms and with respect to donors' gross national product (GNP), which at 0.27 per cent in 1995 was far from the Agenda 21 target of 0.7 per cent; second, successful implementation of many debt relief programmes, which have improved the debt indicators of many developing countries or slowed their rate of deterioration (although further efforts are still needed in sub-Saharan Africa and other highly indebted poor countries); and third, some shifts in official development finance toward social and environmental areas (see table 2).

5. As regards innovative financial mechanisms that can raise new and additional funds, some have already been implemented. Although so far they have raised only a small amount of resources, they represent a promising source of finance for the future. Among those mechanisms the most important at the national level have been economic instruments, such as pollution charges, taxes, subsidy reductions and tradeable permit programmes. At the international level, some promising progress has been achieved by joint implementation programmes, international environmental funds and national environmental funds, which have started attracting external financial resources.

6. In the area of finance, the work of the Commission in the UNCED follow-up process has benefited from work by the Bretton Woods institutions, the Organisation for Economic Cooperation and Development (OECD) and other international organizations. In addition, three expert group meetings on financial issues of Agenda 21, held at Kuala Lumpur in 1994, at Glen Cove, New York, in 1995, and at Manila in 1996, which were sponsored by various donors, provided valuable inputs. A fourth expert group meeting on financial issues was convened at Santiago at January 1997, sponsored by the Governments of Chile and the Netherlands.

7. Sections I-IV below provide a more detailed assessment of the performance of financial mechanisms since 1992, and categorize major developments as significant advances, promising changes and unfulfilled expectations.

I. KEY OBJECTIVES AND MAJOR EXPECTATIONS

8. The main objectives of chapter 33 of Agenda 21 are (a) to establish measures concerning financial resources and mechanisms for the implementation of Agenda 21; (b) to provide new and additional financial resources that are both adequate and predictable; and (c) to seek the full use and continuing qualitative improvement of funding mechanisms to be utilized for the implementation of Agenda 21.

9. Agenda 21 recognizes that, in general, a country's own public and private sectors should provide the bulk of the resources for sustainable development financing. However, ODA was expected to be a main source of external funding for developing countries, especially for least developed and other low-income developing countries. Thus, UNCED reaffirmed the target of 0.7 per cent of developed countries' GNP for ODA. Debt relief of both low and middle-income developing countries was also an explicit concern in Agenda 21, which called for measures to address that problem. Chapter 33 also urged that policies be implemented to increase the level of foreign direct investment (FDI). In addition, UNCED raised expectations about the contribution of innovative financial mechanisms to the mobilization of new and additional financial resources.

II. SIGNIFICANT ADVANCES IN THE FINANCING OF SUSTAINABLE DEVELOPMENT

10. The two major developments concerning financial resources and mechanisms for sustainable development since UNCED are the unexpectedly large increases in private capital inflows to developing countries, and significant progress towards the alleviation of the external debt burden of developing countries.

A. Private capital flows

11. The average of annual private capital flows - excluding export credits - to developing countries from OECD Development Assistance Committee (DAC) countries in the three-year period from 1993 to 1995 was about \$126 billion (about 62 per cent of the total net resource flows from DAC countries to developing countries), which compares with a \$60 billion annual average for the

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period 1990-1992 (which then represented about 45 per cent of the total net resource flows from DAC).^{2/} More importantly, FDI from DAC countries, a type of investment that is more stable and reliable than portfolio investments and international bank loans in the long term, has increased from an annual average of \$25 billion (about 19 per cent of total net resource flows) in the period 1990-1992 to an annual average of \$47 billion (about 23 per cent of total net resource flows) in the period 1993-1995 (see table 1). In real terms, both total private flows and FDI have almost doubled between 1992 and 1995.

12. Developing countries have expressed their concern that private capital flows, in particular portfolio investments, are very volatile, which poses a threat to the stability of exchange rates. Recognizing that, in general, large external capital movements are likely to be the market response to changes in expectations about domestic economic performance, the 1995 meeting of the International Monetary Fund (IMF) Interim Committee enhanced the IMF ability to monitor the economic policies of member countries and increase the transparency of national policies through improved and more timely provision of data. IMF has also substantially increased its capacity to provide emergency funds in case of future threats of currency collapse. At its fourth session, the Commission recommended further in-depth studies on that issue.

13. Developing countries are concerned that private capital flows are concentrated in a few developing countries (12 countries accounted for about 80 per cent of total private flows and three quarters of FDI in developing countries during the first half of the 1990s), mostly middle-income countries in Asia (which accounted for about two thirds of the expansion of total private flows) and Latin America that have adopted outward-looking strategies and sound macroeconomic policies.

14. It can be argued that if one measures those flows relative to developing countries' GNP, both private flows and FDI have been more evenly distributed than their absolute figures indicate. In fact, the average ratios of FDI to GNP have increased for all developing regions since 1990. Nevertheless, an analysis of those figures across countries shows that the ratio of FDI to GNP of the poorest countries is still less than half of that of middle-income developing countries.

B. External debt

15. One of the most important reasons why the poorest economies do not attract private capital is their high level of external debt relative to export capacity. The high level of debt payments has a negative effect on domestic investment, including the investment necessary to attract private capital.

16. Debt-to-export ratios - the main indicators of an economy's ability to repay its debt - of most middle-income developing countries has substantially improved in the 1990s.^{3/} The debt problems of the 1980s for middle-income developing countries have been alleviated through a combination of sound domestic economic policies, liberalization of international trade and capital movements, rescheduling of bilateral external debt and the introduction of new instruments, such as Brady bonds and debt conversion programmes (of which debt-equity swaps have undoubtedly been the most successful, particularly in Latin

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America until 1994). However, the debt burden of heavily indebted low-income countries has not improved in the last several years. In fact, those countries paid only 39 per cent of their total debt service in 1994, and their average debt service ratios are expected to more than double between 1994 and 1997.^{4/} That burden has obviously hampered their development potential and will continue to do so. In fact, the external debt problem of low-income countries has been repeatedly identified by the Commission as a threat to achieving sustainable development, and a more comprehensive and durable approach to assist those countries has been recommended (see E/CN.17/1996/38).

17. During the past few years, important efforts have been made to address that issue. Bilateral donors, particularly the Paris Club, have gradually put in place more comprehensive debt rescheduling and debt relief programmes that in some cases may eventually amount to 80 per cent reductions of selected debt stocks. The International Development Association (IDA) Debt Reduction Facility has also had an important impact on reducing the commercial debt of the poorest countries through buy-back programmes. Those initiatives have achieved the stabilization and even reduction in some cases of the debt stocks of the countries involved, and have thus helped to decrease the rate of growth of the ratio of debt stock to exports. However, that ratio is still unsustainably high and continues to increase. One of the reasons for that deterioration, despite the efforts of debt alleviation programmes, is that such programmes have only addressed partial aspects of the debt problem, leaving some of the largest components of the external debt problem, such as multilateral debt, unresolved.

18. In that context, the initiative of the IMF Interim Committee and the IMF Development Committee, which at their April 1996 meeting proposed a new framework of action to resolve the debt problems of poor heavily indebted countries, is a real breakthrough, because that initiative is based on a comprehensive approach to the solution of the debt problem that recognizes that all the main creditors (bilateral and multilateral) of a particular country should cooperate and coordinate their contributions to the alleviation of the recipient's debt burden. The initiative will target the external debt of 41 of the world's poorest and most heavily indebted countries, and its implementation will be conditional on sound domestic economic policies.^{5/} Total costs are estimated at \$5.6 billion to \$7.7 billion (depending, among other things, on the export performance of the debtor countries), provisionally divided among multilateral (57 per cent), bilateral (41 per cent), and private (2 per cent) creditors. Plans call for phased debt relief by bilateral and private creditors to be topped off by enough multilateral debt relief to bring countries to a sustainable debt position.

III. PROMISING CHANGES IN THE FINANCING OF SUSTAINABLE DEVELOPMENT

19. Given the current scarcity of public resources, additional funds need to be mobilized through increased use of economic instruments (general tax reforms, eco-taxes, subsidy reduction and tradeable permit schemes), increased private-sector involvement, national environmental funds and innovative international financial mechanisms. In addition, further shifts in priorities of international organizations in the allocation of resources to sustainable development objectives are required.

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A. Domestic economic instruments

20. Domestic economic instruments can contribute to the financing of sustainable development in two ways: as an incentive to reduce environmentally harmful activities and as a source of revenue for sustainable development programmes. Proceeds from environmental economic instruments implemented to date, however, are sometimes returned to industry to finance environmental investments and sometimes used to reduce other taxes, thus becoming "revenue neutral".

21. In principle, economic instruments could be effective and efficient instruments for financing sustainable development. In practice, however, their implementation has been limited due to important political and administrative obstacles. The most important obstacles are their perceived effects on income distribution and competitiveness, the need for a well-developed administrative infrastructure to levy them, and the lack of full knowledge about their economic, social and environmental consequences. However, such mechanisms are increasingly being used in OECD countries, as well as in some developing countries and economies in transition.

22. Examples are general tax reforms involving new taxes on fossil fuels compensated by changes in income and general energy taxes in Norway, Denmark, and Sweden; domestic eco-taxes, such as carbon taxes in Finland and the Netherlands; taxes on air and water emissions in several Eastern European and Asian countries; taxes on pesticides and fertilizers in several OECD countries; subsidy reductions, such as the reduction of environmental unfriendly farm and coal production subsidies in several OECD countries; and tradeable permit programmes such as the tradeable sulphur dioxide emission permit scheme in the United States of America and transferable fishing quotas in Iceland and New Zealand.

23. With regard to OECD countries, studies have shown that first, economic instruments do affect the behaviour of polluters and users in the expected direction; second, in general, undesired effects of economic instruments can be compensated for by the use of other policy instruments; and third, redistributive schemes can help to protect industries from the potential loss of international competitiveness that may result from the implementation of economic instruments.

B. National environmental funds

24. Environmental funds are innovative financing mechanisms that can pool revenues from various types of resources (earmarked taxes and charges, concessional grants or loans, debt-for-nature swaps, interest on endowments etc.) to provide long-term funding for environmental programmes. The success of those mechanisms is reflected in their growing number in developed and developing countries and economies in transition that have adopted them.^{6/}

25. Advantages of those mechanisms are that they provide a relatively stable source of funding; attract finance from diverse sources, including external sources; provide accumulated expertise in identifying and managing environmental projects at the national or local levels; and can build capacities of local

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communities and non-governmental organizations. However, they do not always address broader social and economic concerns, they do incur relatively high administrative costs, and they may not always provide the legal and financial safeguards that donors require.

C. Domestic private investment in sustainable development

26. Private-sector investment can be very effective in promoting economic growth and can at the same time have positive social or environmental effects. Examples are efficient power production, water supply and treatment, renewable energy, waste management, and the application of cost-effective and clean technology.

27. In that context, the Commission has repeatedly reminded Governments of the necessary conditions for sustained private investment, including the adoption of macroeconomic, legal and environmental policy frameworks that are clear, credible and stable. In addition, the protection of property rights and access to finance by the private sector are of great importance. Access to finance can be facilitated by deregulated domestic financial markets, promoting co-financing and venture capital funds, build-operate-transfer schemes for the financing of infrastructure projects, and privatizing utilities.

D. International financial mechanisms

28. There are some successful models for international financial mechanisms, such as joint implementation programmes (e.g., the pilot phase for activities implemented jointly (AIJ) established by the Conference of the Parties to the United Nations Framework Convention on Climate Change at its first meeting and international environmental funds (e.g., the Global Environment Facility (GEF) and the Montreal Protocol Environmental Fund (MPEF)) which have transferred developed country resources to developing countries for investments in sustainable development related to the protection of the global environment.

29. After the successful completion of its pilot phase, GEF was replenished by \$2 billion in 1994.^{7/} Joint implementation programmes have expanded significantly: the secretariat of the United Nations Framework Convention on Climate Change reported to the Conference of the Parties to the Convention at its second meeting 32 ongoing or planned AIJ activities worldwide.^{8/} However, both the GEF and AIJ programmes are still small relative to the need for external funds for the implementation of the global aspects of Agenda 21.

30. The incentives for developed countries to participate in joint implementation programmes could be substantially enhanced through the establishment of binding commitments on global and national emission reduction targets (which are absent during the current AIJ pilot phase of the United Nations Framework Convention on Climate Change, and are due for review at the end of the decade). Further replenishments of international environmental funds should be considered, and the 1997 negotiation for a new three-year replenishment of GEF will have special importance in that regard. Both joint implementation programmes and international environmental funds are seeking more involvement of non-governmental organizations and private-sector investors in

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existing and new programmes. GEF and MPEF provide good examples of how public funds can leverage private resources.

Financing sustainable development: the World Bank

Since UNCED, the World Bank has embraced the concept of sustainable development, balancing social and environmental concerns in its lending programmes. There are two promising developments that confirm that trend.^a First, the increased interest of the World Bank in the environmental and social effect of its projects in developing countries, and second, the tenth and eleventh replenishments of its concessional lending arm, IDA.

As regards the environmental and social concerns of the World Bank, starting from a small portfolio for environmental issues before UNCED, the Bank's loan portfolio for environmental projects reached \$10 billion in 1995 and \$12 billion in 1996 (distributed across 137 projects in 62 countries and 153 projects in 68 countries, respectively). Thus, about 36 per cent of the Bank's lending since UNCED has either targeted the environment directly or had some form of positive environmental effect. Furthermore, in 1995 the Bank started providing "green accounting" of the \$87 billion it has committed in the past four years (1993-1996). It has also actively participated in the management of GEF and MPEF, and has started incorporating environmental and social assessments into Bank-financed projects.

The main challenges for the future role of the World Bank in sustainable development are to complement project-specific environmental assessments with a sectoral and regional environmental focus; increase the importance of social assessments of its projects; increase the involvement of the private sector in sustainable development projects; and improve available information on global and environmental trends.

As to funding for IDA, agreements have been reached on the funding for IDA 10 and IDA 11 since UNCED. Agreement on the funding of IDA 11 was reached in March 1996, after difficult negotiations. That pledge, together with other IDA resources (from IDA 10 carry-over, credit payments and contributions of the International Bank for Reconstruction and Development), will enable IDA to fund a programme of special drawing rights (SDR) of 14.5 billion over the next three years, down 6 per cent on estimated requirements and also below the SDR of 16 billion of IDA.^b

^aSee Mainstreaming the Environment, 1995 issues, and Finance and Development, December 1996.

^bSee Development Cooperation, 1996 report (Paris, OECD).

IV. UNFULFILLED EXPECTATIONS

31. The major unfulfilled expectations can be found within the areas of ODA and international tax schemes.

A. Official development assistance

32. The average ODA in the period 1993-1995 was lower than in the period 1990-1992, both in absolute terms and as a percentage of GNP (which at an average of 0.29 in the period 1993-1995 was the lowest level in decades).^{9/} Only four countries achieved the Agenda 21 ODA goal of 0.7 of donor's GNP: Denmark, Sweden, Norway and the Netherlands (see table 2). Measured at 1994 prices and exchange rates, ODA decreased by 9 per cent between 1990 and 1995 (see table 1).

33. The disappointing performance of ODA is particularly important for the poorest developing countries (average ODA to the least developed countries has decreased to below 0.10 of donors' GNP in the first half of the 1990s, far below the 0.15 target of the United Nations Programme of Action for the Least Developed Countries), which have little access to other sources of external finance.

34. The main reasons for the poor performance of ODA in the early to mid 1990s include budgetary austerity in donor countries, poor performance of aid recipients and the belief of some donor countries that private capital flows can substitute for ODA to some extent.

35. At its third session, the Commission proposed ways to enhance the effectiveness of ODA through the elaboration of national sustainable development strategies, with the participation of all interested parties; the use of ODA to leverage additional domestic and external resources, through such schemes as co-financing, joint ventures, underwriting of country risks and venture capital funds; and the promotion of public and political support in donor countries for raising ODA levels.

B. International innovative mechanisms

36. Traditionally, Governments have been unwilling or reluctant to cede sovereign taxation power to international bodies. As a result, not much progress has been made since UNCED in the discussion of international taxes, such as the international tax on air transport, the Tobin tax or an international carbon tax.

37. In its discussions, the Commission has focused on the proposed international air transport tax and the Tobin tax. Although there is agreement that both taxes could be an important source of revenue, there is currently insufficient political will to go much beyond the discussion of technical details.

38. With respect to international tradeable emission permits, the United Nations Conference on Trade and Development (UNCTAD) has undertaken extensive research on the design and implementation of an international tradeable

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greenhouse gas emission programme,^{10/} and is currently cooperating with the Earth Council to develop a pilot emission market.

39. At its substantive session of 1996, the Economic and Social Council discussed new and innovative ideas for generating funds for economic development, and concluded that more research was necessary on that topic.

V. EMERGING PRIORITIES

40. The Commission has discussed the issue of financial resources for implementing the UNCED commitments by taking a comprehensive and balanced approach that focuses on external, domestic and innovative sources of finance. In spite of significant progress in the discussion of finance for sustainable development at both the national and international levels, more research work on the formulation of policy options needs to be undertaken to consolidate the progress achieved so far and address a large number of unresolved issues.

41. Among the most important unresolved issues, for example, are the unfulfilled UNCED commitments on ODA and the crisis of development aid in general. Other issues concerning external finance include the unresolved debt problem of some developing countries and the controversial relationship between FDI and sustainable development.

42. With respect to domestic resource mobilization for sustainable development, it may be necessary to consider a wider range of instruments and mechanisms, and to discuss reforms in such areas as public expenditures (subsidies, military spending and unproductive public expenditures). Furthermore, policy guidance is needed on how to redirect financial resources through macroeconomic and structural reforms. In addition, it will become increasingly important to discuss how greater private-sector participation in the financing of sustainable development can be achieved.

43. As to innovative mechanisms, at the national level it will be most important to promote environmental taxes and charges and learn from the experiences of countries that have made significant progress in that regard. At the international level, the main issues are to enter into a debate on political obstacles and to discuss technical problems in greater detail.

44. The above-mentioned examples of unresolved issues in the debate on finance for sustainable development outline to some extent the unfinished agenda at the national and international levels. A fourth expert meeting on financial issues of Agenda 21 was scheduled to be held at Santiago from 8 to 10 January 1997 to provide analysis and develop policy options on some of the unresolved issues.

Notes

1/ See Report of the United Nations Conference on Environment and Development, vol. I, Resolutions Adopted by the Conference (United Nations publication, Sales No. E.93.I.8 and corrigendum), resolution 1, annex II.

2/ The information on DAC countries contained in this section can be found in Development Cooperation, 1994 and 1996 reports (Paris, OECD). The information on non-DAC countries can be found in World Debt Tables, 1996 (Washington, D.C., World Bank). It is important to clarify that the DAC figures do not include portfolio equity investments or any type of capital flows that developing countries obtain from non-DAC countries (mainly other developing countries in the same region). Adding non-DAC capital flows for the period 1993-1995 would increase the total amount of capital flows substantially. For example, the total amount of private flows to developing countries for the period 1993-1995 would increase by approximately 20 per cent, and total FDI would increase by approximately 60 per cent.

3/ Unless otherwise specified, information contained in this section can be found in World Debt Tables, 1996 (Washington, D.C., World Bank).

4/ See Development Cooperation, 1996 report (Paris, OECD).

5/ See "Heavily indebted poor countries: debt initiative", World Bank pamphlet, November 1996.

6/ See "Environmental funds for sustainable development", proceedings of a seminar for interested members of the OECD/DAC Working Party on Development Assistance and Environment (Paris, April 1995).

7/ See Global Environmental Facility, annual report, 1995 (Washington, D.C.), for more detailed information.

8/ See Joint Implementation Quarterly (Groningen, the Netherlands, JIN Foundation), September 1996.

9/ The information contained in this section can be found in Development Cooperation, 1994 and 1996 reports (Paris, OECD).

10/ See F. Joshua, "Design and implementation of pilot systems for greenhouse gas emissions trading: lessons from UNCTAD's GHC research and development project", paper presented at a conference on controlling carbon and sulphur international investment and trading initiatives, London, Royal Institute of International Affairs, 5 and 6 December 1996.