

Making Environmental Spending Count

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Introduction

Clean air and water are vital for human life, and our societies devote large amounts of money to helping to curb pollution and preserve a healthy environment. Much of that money comes from private sources – businesses pay to dispose safely of environmentally harmful waste, or to mitigate the polluting effects of production processes.

But while technology standards, environmental permits, pollution charges and taxes all have a role to play, public spending is also important in environmental protection efforts.

Governments often pay subsidies to provide environmental public goods, such as the basic levels of sanitation required to safeguard health.

Public funds are also used to make it easier to borrow money on the financial markets for environmental projects, through measures such as risk sharing, credit enhancement, or subsidies to lower the costs of borrowing in communities that cannot afford the full costs of investments. So ensuring that public expenditure programmes are well-managed is an essential element of effective and efficient environmental policies.

This *Policy Brief* looks at how effectively governments use public funds to achieve environmental objectives, and what economies in transition can learn from the OECD experience in crafting and managing their own public expenditure programmes. ■

Why spend public money on the environment?

Environmental policy in OECD countries is generally guided by two key principles: that those responsible for pollution and those using natural resources should bear the full cost of their actions. As its name suggests, the Polluter-Pays-Principle (PPP), developed by the OECD in the 1970s, implies that polluters should pay to cover the full costs of any subsequent clean-up without subsidies. The User-Pays Principle states that revenue generated by users must cover all the costs related to the use of a natural resource such as water or the treatment of resultant pollution or waste.

Both the PPP and the User-Pays Principle aim at avoiding the use of public funds to deal with pollution. However, in some circumstances public spending may be necessary to limit pollution and environmental damage. The PPP specifies that public environmental expenditures may be justified if they are well-targeted (i.e. the environmental objectives to be achieved with the subsidy are clearly identified), limited in size and duration and do not introduce significant distortions to competition or trade; or when polluters cannot be identified.

Environmental public spending needs to be assessed from two angles: environmental policy and public finance. From an environmental policy perspective, the key challenge is to ensure that public expenditure achieves the intended result at least cost, and that it forms part of a coherent strategy for achieving environmental objectives. From a public finance perspective, expenditure should be managed in accordance with established standards of good governance – in other words, value for money. When choosing which environmental programmes to finance, governments should ensure that the expected social benefits from any spending programme exceed the expected social costs. If the benefits are difficult to measure, governments can instead test how cost-effectively an environmental programme achieves its objectives. ■

How to manage such spending?

A key question in managing public spending is whether revenue from specific taxes or charges should be earmarked to help pay for specific services. Such earmarking is a popular practice for environmental authorities. It offers predictable financing for environmental projects, and is politically popular as it clearly links revenue to a particular social benefit, which helps make new taxes more acceptable.

But earmarking funds also limits flexibility in public spending and may mean that resources are not allocated efficiently. It may also lead to environmental issues being marginalised in the mainstream budget process. Under certain conditions, however, earmarking is perceived as a price worth paying for predictable financing for priority environmental measures. In such cases, earmarking should not go beyond the timeframe necessary to achieve the stated objectives.

Once revenues have been collected, governments need a structure for disbursing them on environmental projects. Special environmental funds are a popular way of channelling public expenditure for the environment in both OECD and non-OECD countries, but the way they operate differs widely.

In OECD countries where such funds exist, they tend to focus on one environmental medium – such as water, air or waste treatment. This makes for more efficient management since it is easier to define environmental

objectives and to monitor results than if the funds were allocated for the environment in general. It also makes it easier to target human and financial resources and to adjust the programmes if necessary.

In Austria, for example, the government operates three funds supporting environmental investment: a Water Management Fund, an Environment Fund and a Contaminated Sites Remediation Fund. Between them they provide almost 300 million euros in investment support each year, leveraging investments of over 1.1 billion euros. The Funds are administered on behalf of the minister of environment by Kommunalkredit Public Consulting, the daughter of a bank specialised in public finance. Similarly, in France, six regional public water agencies are responsible for collecting and spending public investments in the water sector. They have a high degree of autonomy and on average, handle a total budget of more than two billion euros a year.

In the OECD's most recent European members (Czech Republic, Hungary, Poland, Slovak Republic), environmental funds have a wider remit, and most of them are used to manage revenue from the EU Cohesion and Structural Funds, as well as to provide co-financing for investments supported by these funds. The Funds in these countries are legal entities with well-established supervisory and executive management structures.

In Central and East Europe (CEE), as well as in Eastern Europe, Caucasus and Central Asia (EECCA) countries, broad environmental funds are the predominant instrument for managing public environmental expenditure programmes. Most of this money is spent on reducing pollution in the air and water sectors. But the revenue of these funds is small compared to OECD countries, and is often too low to allow significant spending on capital investment, especially in EECCA countries, so the money is often allocated for activities such as monitoring. The two major exceptions are the State Environmental Fund of Ukraine, and the National Environmental Fund of Moldova, which manage about 4 million euros and 15 million euros respectively.

Typically, the environmental funds in CEE and EECCA countries are domestic public institutions, capitalised by earmarked pollution charges, pollution fines and product charges. They provide financing for a wide range of environmental improvements for both the public and private sector, most often in the form of grants and soft loans. Most CEE and EECCA countries have also established environmental funds on national, regional and/or local levels. Funds vary in terms of their legal status and their relationship to the government. Most funds are not legal entities, but are part of the environment ministry. ■

What can be learned from OECD countries' experience?

The OECD has studied schemes providing subsidies for the water sector through targeted multiyear investment programmes in four member countries (Austria, Belgium, France and Germany) to see how their experience can help transition economies. This focused on analyzing the various institutional set-ups and approaches adopted, including the role that the private sector can play in managing such programmes.

Outsourcing the management of spending programmes and private sector participation are key features of the schemes reviewed in the four OECD countries. Initially, state authorities were responsible for managing public

subsidy schemes. Over time, the pressure on public administrations has been partially relieved by bringing in private sector agencies to take over managing the schemes for a fee.

However, outsourcing is only an option if the government has very strong control over the implementing agency's operations and develops clear rules, procedures and criteria for regularly evaluating the agency's performance. The case of Flanders highlights the need for good control measures. Until recently, the public-private partnership Aquafin, which is responsible for implementing a public investment programme for wastewater treatment at regional level, was having problems achieving the water quality targets specified in its government contract. A new incentive structure and more focused monitoring have been introduced to improve Aquafin's performance.

The OECD subsidy programmes that were studied have clearly set timeframes and are adjusted or closed when they have achieved their objectives or when other policy instruments become more relevant.

Beyond public financing schemes, user charges are the only sustainable long-term financing option for environmental investments. User charges in France and Germany have been raised to cost-recovery levels and now generate enough revenue to cover at least the operating and maintenance costs of water utilities, but also as far as possible investment in new water supply and sanitation infrastructure. Thus, in the OECD countries, public environmental expenditure programmes are part of a gradual transition from public subsidy schemes to financing through user charges. ■

Box 1. THE POLISH ECOFUND

The Polish EcoFund is renowned for its well-designed expenditure programmes and rigorous management procedures based on the following criteria:

- a strict framework of clearly defined environmental priorities and project eligibility criteria;
- clear requirements for, and strictly professional relations with, applicants;
- clearly defined appraisal and selection criteria emphasising environmental benefits and cost-effectiveness; and
- careful monitoring of projects to ensure proper use of funds and achievement of environmental effects.

These procedures lead to objective, transparent and accountable decision-making. In addition, EcoFund's application procedures help create project preparation skills and promote the development of the environmental goods and services industry in Poland.

The Polish EcoFund Foundation was established to manage the revenue generated through debt-for-environment swaps (DFES). In 1991, Poland signed an agreement with the Paris Club of creditor countries to reschedule its external debt. As a result, half of the Polish debt was cancelled and part of the repayments on the rest is transferred to the EcoFund for environmental projects. Six creditor countries (United States, France, Switzerland, Italy, Norway and Sweden) have taken part in this scheme.

As a result, the EcoFund has had a stable and predictable source of revenue. Over the full debt repayment period to 2010 the Polish EcoFund expects to receive DFES revenues totalling USD 571 million. Although the sum is relatively small in the context of overall environmental financing in Poland, its impact is significant due to EcoFund's powerful leveraging effect on other financial sources. EcoFund's close attention to achieving high benefit/cost ratios offers reassurance that the DFES revenue has not resulted in the inefficiencies sometimes associated with earmarked programmes.

What is transition countries' experience?

The full application of PPP in transition economies has been constrained by a number of problems, such as weak or ineffective enforcement of environmental policy, severe financial constraints on enterprises and households, uncertainties in fiscal systems, poorly developed banking systems and capital markets, and inadequate information on the cost of environmental damage.

OECD has developed a framework to measure the level of environmental expenditure in member countries, ensuring the collection of reliable and internationally-comparable data. This framework covers the flow of capital and recurrent expenditure, subsidies and fees that are directly aimed at environmental protection, whether incurred by the public sector, the business sector, specialised producers of environmental services or private households.

Most transition and developing countries do not use these classifications, but it is nonetheless possible to measure and compare overall environmental expenditure between EECCA countries. In the bigger EECCA economies (the Russian Federation, Kazakhstan, Ukraine), environmental spending accounts for 1.2%-1.6% of GDP and has increased to levels which compare with some CEE countries. In poorer EECCA countries (Moldova, Georgia, the Kyrgyz Republic, Tajikistan), they represent on average between 0.2% and 0.8% of GDP. The public sector share of this expenditure is generally below 30% in EECCA, while it ranges between 12% and 80% in OECD countries.

Virtually all EECCA environmental funds (with the exception of Ukraine) have remained insignificant players in financing environmental expenditure. One of the fundamental problems facing EECCA in achieving more efficient allocation of public financial resources for the environment is a lack of well-developed expenditure programmes. As a result, environmental funds in EECCA suffer from excessive discretion, *ad hoc* political influences and blurred accountability. Responsibilities for appraising and selecting publicly-financed projects are usually unclear, leaving a lot of room for mismanagement and misuse of public resources. Eligibility criteria, procedures, priorities and targets are not specified or are defined in very vague terms.

A major trend in recent years in response to pressure to improve public spending and strengthen fiscal discipline has been to consolidate extra-budgetary environmental funds in both CEE and EECCA into national budgets. In Ukraine, for example, the State Environmental Fund is now part of the state budget process. A recent review of the performance of the Fund has indicated that the strict national budget rules have led the Fund to follow a prudent fiscal policy. ■

How to assess environmental public spending programmes?

The experiences above indicate that there is room to improve the performance of public environmental spending programmes. In particular, transition and developing countries could learn from OECD countries to design and manage these programmes so that they will contribute to the efficient and effective implementation of environmental policies.

The OECD has developed Good Practices for Public Environmental Expenditure Management (PEEM) to assess the performance of institutions managing public environmental expenditure programmes. The OECD has studied how far the national and regional environmental funds of a number

of transition economies comply with these Good Practices. The results have been used to prepare reform plans to improve the performance of the institutions involved.

The Good Practices cover three key areas: environmental effectiveness; budgetary good practice and management efficiency. *Environmental effectiveness* concerns the performance of public expenditure programmes as instruments of environmental policy. *Budgetary good practice* covers how to align the programme with the principles of sound public finance. *Management efficiency* considers how efficiently a financing institution uses financial and human resources.

The OECD has developed checklists of five major principles for each of these areas, plus criteria for putting them into practice. The checklists can be used to measure how far public environmental expenditure programmes comply with the Good Practices.

The results of such an assessment can be displayed using a performance triangle. Box 2 shows the performance of Ukraine's State Environmental Fund with regard to the Good Practices for PEEM. The larger (pale blue) triangle represents the best practice that the Fund can achieve, while the smaller (dark blue) triangle shows the actual performance of the Fund. The space between the two triangles shows the room for improvement.

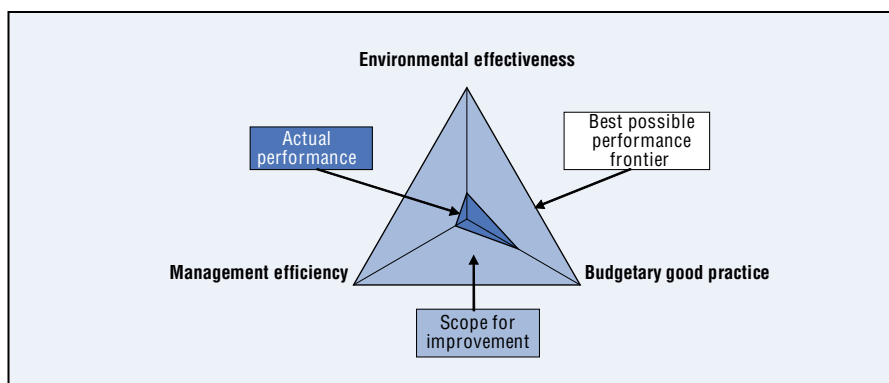
Due to reforms implemented in Ukraine's public finance system, its environmental fund scores best in terms of budgetary good practice. But the Fund's compliance with the Good Practices is poor when it comes to environmental effectiveness and management efficiency. This low performance shows the need for a significant targeted institutional reform and strengthening of the Fund to bring it into compliance with internationally-recognised standards for such institutions. ■

How to implement good practice?

Implementing the Good Practices for PEEM must take into account the specific objectives to be achieved and the design of the programmes, which will be shaped by national administrative traditions, the level of economic development, as well as the maturity of markets and the public finance system. The choice of the institutional set-up should be tailored to the specific needs of a given programme.

Box 2.

PERFORMANCE ASSESSMENT OF THE STATE ENVIRONMENTAL FUND OF UKRAINE



One of the main conclusions from the work on PEEM in economies in transition is the need for practical management tools that managers of public expenditure programmes can use as a benchmark to improve effectiveness and efficiency. This has prompted the development of an OECD *Handbook for Appraisal of Environmental Projects Financed from Public Funds*.

The *Handbook* is aimed at the public financier who is responsible for selecting the most cost-effective projects proposed by project developers. It presents a step-by-step approach for programming and project cycle management and offers a menu of options and management tools to choose from, depending on the needs and maturity of the individual institution concerned. The *Handbook* focuses on investment projects, with most of the examples using wastewater collection and treatment projects to demonstrate the value of the different approaches proposed.

On the basis of the *Handbook*, a toolkit of training materials has been developed and pilot tested in EECCA. It includes a simple model for calculating the cost-effectiveness of environmental infrastructure investment projects.

Decision-makers can use the Good Practices to assess the performance of the agencies managing public environmental expenditure programmes. Managers in implementing agencies can use the Good Practices evaluation framework for self-assessment and for tracking progress in their development.

Managers of technical assistance programmes concerned with financing environmentally-related investments and consultants working on public finance issues may also find the tools useful.

Although the documents were initially developed to support reform in the CEE and EECCA countries, the major principles, tools and approaches are relevant for any developing and emerging economy wanting to improve public environmental expenditure management in line with international standards. OECD countries can also use these tools to further enhance their environmental public spending management practices. ■

For more information

For more information about OECD's work on public environmental expenditure management, please contact: Nelly Petkova, tel.: + 33 (1) 45 24 17 66, e-mail: nelly.petkova@oecd.org or see www.oecd.org/env/finance.

Box 3.

KEY STEPS IN ESTABLISHING, MANAGING OR REFORMING PUBLIC ENVIRONMENTAL EXPENDITURE PROGRAMMES

- Define priority environmental objectives using evaluation methods, such as risk assessment and benefit-cost analysis as well as participatory political processes.
- Demonstrate whether public expenditures are necessary to achieve these objectives.
- Define sources of revenue, budget size, and the terms and conditions of the expenditure programme.
- Authorise an appropriate institution to manage the expenditure programme.
- Continue, modify or terminate the expenditure programme in light of periodic reviews of the programme's performance to assess whether its objectives have been achieved and its continuation is necessary.



For further reading

OECD (2006), **Mechanisms for Managing Public Environmental Expenditure in Selected OECD Countries**, available for free download at www.oecd.org/env/finance or www.oecd.org/dataoecd/21/48/37744488.pdf.

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