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Programme element II.a

Matters left pending on the need for financial resources

Note by the Secretariat

SUMMARY

Substantial financial resources are needed for the sustainable forest management of all types of forests, but new and additional resources are not seen as forthcoming as expected, despite commitments from both international and domestic public sources. The financing situation in developing countries with low forest cover is especially serious. Private capital flows to forest activities are increasing, mostly from international sources but also from within some of the developing countries. However, such capital flows, aimed at more traditional extractive operations, may not contribute significantly to sustainable forest management. The private sector also faces problems in gaining access to the start-up capital and in overcoming fear of risks and uncertainties involved in newer operations. Private-sector capital flows are unevenly targeted, aimed generally at countries with extensive forest cover. There is a need for policy reforms providing tax, financial and other incentives conducive to sustainable forest management while eliminating subsidies that are detrimental to it.

The present note discusses some conventional and innovative financial mechanisms used in other sectors and countries and their potential use in the forest sector of developing countries. It also discusses issues relating to an international forest fund, the Global Environment Facility and other instruments, and recent developments that have opened up new windows of opportunities for forest-sector financing.

Conclusions and proposals are summarized at the end of the note.

CONTENTS

I. INTRODUCTION

1. At its first session, the Intergovernmental Forum on Forests (IFF) decided that, at its forthcoming sessions, under category II.a, it should consider urgently the following options for action:

(a) Urge the establishment of an international fund to support activities for sustainable forest management;

(b) Pursue action to enhance funding in other ways, inter alia, by inviting the United Nations Development Programme and the Bretton Woods institutions, together with other relevant international organizations, to explore innovative ways both to use existing financial mechanisms more effectively and generate new and additional public and private financial resources at the domestic and international levels in order to support activities for the management, conservation and sustainable development of all types of forests.[1]

2. This note provides updated information on programme element II.a, designated for background discussion at the second session of the Forum. It builds on reports of the Ad Hoc Intergovernmental Panel on Forests on financial assistance and related concerns. In particular, it reviews the Panel's conclusions and proposals for action related to financing; assesses current status, new developments and issues of financing; and identifies further work needed and suggests some preliminary conclusions.

II. CONCLUSIONS OF THE AD HOC INTERGOVERNMENTAL PANEL ON FORESTS AND PROPOSALS FOR ACTION

3. The Ad Hoc Intergovernmental Panel on Forests, at its fourth session came to the following conclusions on financial assistance:[2]

(a) The issues of financial assistance are crosscutting, interlinked and essential;

(b) Current financial resources are insufficient;

(c) Financial needs should be met by domestic sources, but international financial sources are vital;

(d) Overseas Development Assistance (ODA) remains the main source of external public funding, particularly in those developing countries with low forest cover;

(e) The declining trend of ODA is a matter of concern;

(f) Forestry projects contributing to global environmental benefits should also get support through available international mechanisms such as the Global Environment Facility;

(g) Private capital flows to developing countries are an encouraging phenomenon, but their flows are uneven;

(h) There is need for enhanced international cooperation to address the debt problems of developing countries;

(i) Market-based instruments, such as taxes, levies, user fees and domestic public investments, are desirable;

(j) Properly valuing forest resources and creating markets that reward sustainable forest management would contribute to sustainable forest management;

(k) In-country coordination among donors is crucial.

4. The Panel proposed the following action for all countries, both developed and developing, and international organizations to strengthen financial assistance:

(a) Act collectively to increase financial resources;

(b) Increase ODA but also improve the absorptive capacity of developing countries to use such resources and enhance their domestic revenue generation capacity;

(c) Improve coordination among donors and recipient countries; base coordination and collaboration on country-driven national forest programmes; and avoid duplications and inefficient allocation of international public funds.[3]

5. The Panel urged the developing countries to prioritize forestry activities, internalize externalities associated with land use and forest policies, maximize rent capture, reinvest a greater share of forest revenues in sustainable forestry, and better coordinate; encourage private sector investments in forestry through various financial and tax incentives; increase revenues through market-based instruments; encourage voluntary codes of conduct by the private sector; and encourage mobilizing local community financial resources.

6. The Panel also recalled the Rio Declaration on Environment and Development,[4] stating the need for new and additional financial resources for developing countries, and urged the donor community to work with developing countries to identify the need and resource availability of those countries for sustainable forest management; increase concessional lending through international institutions; continue efforts to find efficient, equitable, development-oriented and durable solutions to debt problems of developing countries; and encourage their private sector to invest in sustainable forest management activities in developing countries through appropriate financial incentives and guarantees.

7. While the Panel invited international organizations such as the United Nations Development Programme (UNDP) and Bretton Wood institutions to explore innovative financial mechanisms, it found the world community not yet ready to establish an international fund devoted to sustainable forest management.

8. By revisiting the issue of an international fund, and urging UNDP, Bretton Woods and other institutions to continue engaging on innovative financing mechanisms, IFF noted a continued willingness on the part of the world community to consider ways to generate and allocate resources for sustainable forest management.

III. CURRENT STATUS OF FINANCIAL MECHANISMS

A. Trends

9. In 1997, the Fourth Expert Group Meeting on Financial Issues of Agenda 21 observed the following three general financing trends in regard to sustainable development activities:

(a) Policy reforms favourable to environmental conservation and economic development were increasing;

(b) Both official development assistance (ODA) and domestic resource mobilization had fallen far short of the commitments made at the United Nations Conference on Environment and Development;

(c) Private capital flows from developed to developing countries had increased significantly.[5]

10. Generally speaking, the forest sector has seen similar trends. Several countries, both developed and developing, are embarking upon policy reforms in the forest sector, focusing on the sustainable conservation, management and sustainable development of all types of forests.

B. Financial needs and sources of funds

1. Needs

11. The United Nations Conference on Environment and Development stipulated a need for $31.25 billion annually, for the period 1993-2000, to promote sustainable forest development. Taking into account the costs due to deforestation and other social and environmental effects, more recent estimates put funding requirements for sustainable forest management as high as $70 billion per year. However, actual funding available in the forest sector from all sources falls far short of even the more conservative estimate of the Conference.

2. Domestic public sources

12. The United Nations Conference on Environment and Development aimed to raise $25.58 billion (82 per cent) of the $31.25 billion annually from domestic sources (both public and private) and $5.67 billion (18 per cent) from foreign sources. Given the social and economic constraints of most developing countries, the intent to mobilize such a large share of domestic funds appears

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very ambitious. Some countries such as Bangladesh and the United Republic of Tanzania, can finance less than 20 per cent of their current forestry expenses through domestic resources. For various reasons, many countries are unable to raise public funds for the forest sector. Problems are further compounded by low levels of general economic growth, a lower priority of the forest sector in national policy (thus, a smaller budget allocation), and the desire to treat forests as a source of quick revenue or even as an obstacle to economic development.

3. Domestic private sources

13. Despite the new wave of economic liberalization, many developing countries have limited private participation in forestry, particularly in the areas meaningful to sustainable forest management. Only a few developing countries, such as Brazil and Chile, have substantial private investment in forest products industries.

4. International public sources

14. ODA has been declining in the 1990s. The ODA in forestry for the year 1993 was only $1.54 billion, a little more than a quarter of what was estimated at the Conference. Ironically, ODA in general has declined in the years following the Conference. Moreover, the flow of ODA is not quite equitable among countries.

5. International private sources

15. The rapid economic globalization has seen increasing private international capital flows in developing countries. However, private investment does not flow to regions or countries uniformly. Private capital flows in the forest sector, although difficult to measure, are growing and are estimated to be around $8-9 billion a year from both domestic and foreign sources. Such private capital flows originate mainly in developed countries, but flows between developing countries are also growing. Transnational corporations are the main source of private foreign capital flow in forestry in developing countries.

16. These foreign capital flows in forestry in developing countries represent both a potential opportunity to attract private investment in forestry, particularly in light of declining external public funding, and a possible threat to long-term forestry, if business as usual continues. Much of current private capital flow is directed to conventional extractive operations and export trade, with the object of capturing as much rent as possible.

17. Yet, the involvement of transnational corporations could assist developing countries in capital formation and facilitate the transfer of technologies, human capital development and expansion of markets. Nevertheless, investment by transnational corporations and other private sources is driven by their profit motives and may not always coincide with the national interest of the recipient countries. Moreover, such capital flows generally favour countries with

substantial forest cover and other comparative advantages; developing countries with low forest cover are less attractive for private-sector investment.

18. Despite the increasing trend of private capital to flow to developing countries, the decline in official international capital is a matter of serious concern, because long-term development aid catalyzes and complements private investments. Cutbacks in international aid affect forestry and environment programmes, which, although essential elements in the economic and social development of a country, generally attract little private-sector funding due to their "public good" image. This has had a negative effect on a number of the least developed countries which have little capacity to attract domestic and foreign private savings and are traditionally dependent on official development aid.

C. Implementation of the Panel's proposals for action

19. Certain countries, with the help of international organizations, have moved forward with the Panel's proposals for action. Recently four - Costa Rica, Cameroon, Guyana and Viet Nam - started to implement the Panel's proposals for financial assistance with the help of the UNDP Global Programme on Forests (GPF). The participating countries have started working independently to design financial mechanisms most suitable to their own circumstances.

20. Guyana has recently adopted a new forest policy and is in the process of passing a body of laws to implement it. Viet Nam has adopted a national reforestation programme to mobilize its communities to finance substantial reforestation activities.

21. In another initiative, six countries - Finland, Honduras, Germany, Indonesia, Uganda and the United Kingdom - plan to work together to implement the Panel's proposals for action, including those on financing.

IV. RECENT DEVELOPMENTS

A. Climate change, carbon and forest linkages

22. The Kyoto Protocol to the United Nations Framework Convention on Climate Change[6] has aroused new interest in forests. The recognition of forests as a carbon sink and the agreement to establish an international-emission offset trading regime have opened a potential source of revenue in the forest sector. Countries that grow and maintain forest resources can thus be financed (compensated) by countries or industries that emit carbon dioxide, using a market-based instrument. Many technical and legal issues are yet to be explored and clarified. Being global in dimension, a carbon-offset programme calls for a global mechanism to resolve issues and regulate and monitor transactions.

23. Several countries and organizations are interested in examining the carbon-offset potential of forests and the financial opportunities it offers. Many initiatives are under consideration. The World Bank is studying prerequisites for creating carbon-offset markets the feasibility of using such markets to

promote forest conservation goals, and issues related to various climate change instruments, including carbon investment under its global carbon trading initiatives.

24. Costa Rica has been successfully using carbon-offset trading to generate funding for sustainable forest management. Guyana is exploring the market potential and marketing strategies of its forest-based carbon-offset market.

25. Some initiatives in this direction are being taken in the private sectors of industrialized countries. The Sampson Group in the United States of America is an example of an entity in the private sector implementing forestry projects for carbon offsets. Similarly, Alabama Power Company offers financial incentives to private landowners to plant trees to offset carbon emissions.

B. Asian currency and financial crisis

26. The currency and financial crisis in a number of Asian currencies in 1997 has had far-reaching consequences in national, regional and global economies. In the forest sector, the immediate impact was severe. In timber-producing countries the costs of financing soared, while the price of many timber products dropped. The instability of the banking sector made it difficult for timber exporters to obtain loans for working capital or commercial credits to import machinery and spare parts. The currency devaluation limited the Government’s capacity to maintain subsidies deemed necessary to achieve certain social and economic goals.

27. The crisis has heightened awareness of the role of capital flows in economic development. It revealed the weaknesses and shortcomings of the Asian economies and exposed the risks of uncontrolled capital flows amid weak national financial institutions. It also underscored the importance of an orderly and properly sequenced liberalization of capital movements, the need for appropriate macroeconomic and exchange rate policies and the critical role of sound financial sectors and effective prudential and supervisory systems. It showed that without sound and transparent financial and banking systems, it is difficult for a country to sustain economic growth.

28. How the Asian crisis will affect financial mobilization in forestry, particularly for sustainable forest management, is yet to be seen. However, it may have made the financing of long-term sustainable forest management operations even more scarce and difficult. The international community needs to monitor events closely and consider developing emergency funds for crisis management.

V. AN INTERNATIONAL FOREST FUND AND OTHER INNOVATIVE FINANCING MECHANISMS

A. International Forest Fund

29. A number of international instruments with a bearing on forests exist - most notably, the Convention on Biological Diversity,[7] the Convention to Combat

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Desertification,[8] the International Tropical Timber Agreement, and the Global Environment Facility - but they are designed to meet specialized needs and may address issues of sustainable forest management only partially. Sustainable forest management involves all aspects of forestry and land use, including conservation, management, utilization, processing industries, trade of timber and non-timber products and services, and the welfare of forest-dependent communities. Therefore, the comprehensive needs of an international forest fund cannot be met effectively by these specialized international funding mechanisms on their own.

30. In some developing countries, low forest cover and low GDP limit the capacity to invest in sustainable forest management. Many such countries, therefore, fail to attract foreign private-sector funds to their forestry sector. Although sustainable management of their forests could be vital for those economies, the specialized international instruments mentioned above may not be available to them. In such cases, an international forest fund would be a very important source of financing.

31. The Global Environment Facility (GEF) finances forestry activities that have direct global environmental benefit - for example, those concerning land degradation - primarily desertification and deforestation. It does not finance other aspects of forestry specific to sustainable forest management. A comprehensive evaluation of GEF and other international financial mechanisms would help policy makers determine whether a special international forest fund is desirable.

B. Innovative financing mechanisms for sustainable forestry

32. Financing in sustainable forestry is a complex process, due to the many special features of forestry. Sustainable forestry is an emerging sector that requires considerable clarification in terms of concepts and approaches. Forests represent both inventory and capital. A long rotation period causes investment uncertainties because of biological and market risks affecting final returns on investment. Such time requirements also highlight other characteristics of forestry: irreversibility and delayed cash flow. These uncertainties create problems in gaining access to credit and in setting terms. There are externalities associated with the growth of trees and other forestry operations that are not always reflected in conventional market transactions.

33. Increasing private-sector financing (both domestic and foreign) involves "selling" forestry opportunities as equally viable and competitive as other investment options. The lack of interest in forestry investment by private landowners is a problem common to both developing and developed countries. In general, strategies to generate interest in forestry investment include:

(a) Increasing private returns through financial subsidies and public technical assistance;

(b) Reducing investment risk and uncertainty;

(c) Eliminating or significantly reducing the cash flow problems associated with the long-term nature of forestry operations.

34. Some of the ways to address the low financial rates of return include fiscal subsidies and incentives, beneficiaries cost-sharing and increased productivity and efficiency of operation.

35. Reducing cash-flow problems in forestry investment would be a significant way to attract private investment in forestry. Special forestry concessional loans, with longer grace and payback periods, contractual arrangements with industries and other forest product users, and cost-sharing by public sources (both domestic and ODA) need consideration.

36. The "debt-for-nature swap" is perhaps the oldest innovative financing mechanism in forestry operations and has retired $159 million in face value of debt so far. However, the use of this mechanism has declined in recent years.

37. A forest fund is another device commonly used to finance specific activities for forest development. Sources for most such funds come from earmarked taxes and receipts from sales of forest products. Although the funds provide a ready source of financing for forestry, they face criticism from optimal investment criteria of public funds.

38. Use fees, levies and charges are other ways to increase revenue: beneficiaries are charged for the range of services provided by forests, particularly for watershed protection. A mechanism that required downstream beneficiaries to pay the upstream forest landowners for their watershed services has long helped to fund upland conservation in Japan. In Costa Rica and Colombia, portions of the revenue from hydroelectric companies provide funds for watershed management programmes.

39. Providing access to credit to small forestland owners and entrepreneurs can be improved through concessional micro-finance programmes using private and public sources. While access to concessional credit is essential, steps to reduce the risk of loan defaults to lending agencies are equally important. Public loan guarantees and other legal safety mechanisms to lenders and cooperative arrangements among borrowers, particularly small farmers, improve credit availability.

40. Many governments use tax incentives such as tax holidays, subsidies, exemptions, abatements, lower tax rates, outright cash grants and other incentives to encourage private investment in particular economic sectors, such as manufacturing. With tax incentives it is important to understand the role they play in investors’ decision calculus and to avoid subsidizing investors unnecessarily with public money.

41. Innovative financing in sustainable forestry might adopt some of the cost-share programmes used in the United States of America. Under those programmes, federal and state governments offer cost-sharing payments to partially offset private landowners’ expenses for tree plantation and forest management activities.

42. Incremental tax financing is a mechanism used to pay back public financial support to establish a private industrial facility through a special fund. This mechanism can also be used in leveraging private-sector investment in forest product industries. In addition, joint enterprises and modified conventional capital market instruments to finance sustainable forest management projects show good prospects.

43. ODA can be effectively used to leverage private funds. It can be used to facilitate public/private partnerships, strengthen institutional mechanisms and technology transfer, and provide seed capital.

44. Biodiversity patents or bio-prospecting fees involve creating an international legal basis for licensing biodiversity use and extracting a payment commensurate with its economic value.

45. The Tobin tax is a tax on foreign exchange transactions that can fund environmental cleanups and sustainable forestry. The tax has a potential to generate substantial revenue and discourage short-term speculative transactions across currencies and nations, which are potential contributors to currency crises (e.g., the Mexican peso crisis). The dominant players in foreign currency markets are private banks. While volatile currency markets are bad for a national economy, they are advantageous to that community.

VI. PRELIMINARY CONCLUSIONS AND OPTIONS FOR FURTHER ACTION

A. Conclusions

46. The conclusions reached by the Panel at its fourth session regarding the issues of financial resources for sustainable forest management in developing countries still hold true. The financial needs for sustainable forest management are substantial, and the capability of most developing countries to mobilize domestic resources is limited. Many policy reforms on improving public funding and encouraging private financial inflows into sustainable forest management are yet to be achieved, although some positive actions are seen in the case of some countries.

47. For many developing countries, particularly those with low levels of economic development and with scarce forest resources, ODA will continue to be the major source of financing for their forest-sector activities. With the help of ODA and domestic public funds, private capital could be directed to more sustainable forestry activities in forest stands, industry and trade.

48. Recent developments in the negotiations on climate change and the Asian currency crisis have once again revealed the interlinkages of forestry with broader economic and environmental matters.

49. UNDP, under its Global Programme on Forests, has launched a number of pilot cases, in collaboration with four countries, to design and test innovative financial mechanisms suitable to specific countries. Similarly, the World Bank is working on its Carbon Investment Fund mechanism. Many other countries and

international organizations are exploring new ways to generate resources through policy reforms.

50. Lack of reliable data on financial resources is a serious limitation to an understanding of the magnitude of the problem and the achievements made by different countries. In the past, the Food and Agriculture Organization of the United Nations (FAO) used to maintain data on many aspects of forestry for all countries. However, lack of resources and other support have limited its capacity to gather and synthesize such data. This matter should get serious consideration from the global community, in general, and from IFF, in particular.

B. Proposals for action

51. In order to support the financing of sustainable forest management activities, the Forum may wish to consider the following proposals for action:

(a) Urge countries to increase their ODA contributions targeted at sustainable forest management in developing countries;

(b) Urge countries and relevant organizations in the forestry sectors, such as the International Tropical Timber Organization, UNDP, FAO, the World Bank and regional banks seriously to consider and explore the possibilities and needed frameworks for carbon offset trading and other emerging potential revenue sources of forests;

(c) Request relevant organizations in the forestry sector to work collaboratively with country forest and finance agencies to introduce and continue using market-based instruments such as user fees and increased rent capture, to devise incentives for investing in sustainable forest management practices and to eliminate subsidies and to impose taxes on unsustainable forestry and land-use practices that affect forest sustainability;

(d) Urge developing countries to formulate policies that facilitate private investment in sustainable forest management;

(e) Urge developed countries and multilateral organizations to support the capacity-building efforts of developing countries to improve their planning and implementation of sustainable forestry activities and their capacity to absorb ODA;

(f) Urge developed countries and multilateral organizations to provide loan and investment guarantees, matching funds and other supports to promote private-sector investment in sustainable forestry in developing countries;

(g) Urge developed countries and multilateral organizations to foster partnerships in forestry financing between the private sector in the developed countries and the private and public sectors in the developing countries.

52. In view of the inadequacy of information on investment in forestry, the Forum may wish to urge its member countries to support activities for systematic

data collection and analysis, in order to make reliable, updated information available and to foster information sharing.

53. The Global Environment Facility (GEF) is one international fund that could provide information and lessons on the proposal to establish a new international forest fund. The Forum may wish to urge organizations and countries directly involved with GEF to review the GEF mechanism and learn from it.

54. The preparation of the Secretary-General's report on IFF programme element II.a will benefit from additional guidance provided by the Forum.

Notes

[1] See E/CN.17/IFF/1997/4, para. 7.

[2] See E/CN.17/1997/12, paras. 59-66.

[3] Ibid., paras. 67-71.

[4] Report of the United Nations Conference on Environment and Development, Rio de Janeiro, 3-14 June 1992, vol. I, Resolutions Adopted by the Conference (United Nations publication, Sales No. E.93.I.8 and corrigenda), resolution 1, annex I.

[5] See E/CN.17/1997/18, Chairman's summary.

[6] See FCCC/CP/1997/7/Add.1.

[7] See United Nations Environment Programme, Convention on Biological Diversity (Environmental Law and Institution Programme Activity Centre), June 1992.

[8] A/AC.241/27.
