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Tasks of the Expert Group

Financing for sustainable forest management: current challenges in the changed financial environment

Note by the Secretariat

Summary

The present note provides background information to assist the Ad Hoc Expert Group on the Finance and Transfer of Environmentally Sound Technologies in carrying out its tasks.

Financing is a pervasive issue in the international development policy framework. Adequate financing for sustainable forest management is directly linked to poverty alleviation, improved food security, access to safe drinking water, affordable energy, changing unsustainable patterns of consumption and production and protecting and managing the natural resource base of economic and social development.

Currently several market and policy failures decrease the profitability of sustainable forest management. Also, perverse incentives and higher profits in other economic sectors contribute to deforestation and forest degradation. Considering the decline in overseas development assistance, which has seriously affected the primary production sector in developing countries, it is difficult to build realistic financial strategies based on an increasing role of official development assistance flows. On the other hand, private investments have been increasing, but the investment climate in forestry is currently not competitive. Furthermore, most of the foreign direct investment goes to a very limited number of countries. For the vast majority of developing countries official development assistance remains the backbone of financing.

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These challenges highlight the importance of sustainable forest management to increase revenue collection, attract private investments and eventually decrease dependence on external financing. Increasing revenue collection, payment mechanisms for non-market benefits and transparent and coherent long-term forest policies, including incentives are elements of a comprehensive financial strategy. The role of the public sector is crucial for creating legal, policy and institutional frameworks for stable and transferable property rights. Many of the preconditions require intersectoral efforts and integration of sustainable forest management into development and investment strategies. There is also an urgent need for the forestry sector to demonstrate its contribution to environmental quality and well-being, poverty alleviation and rural development, among other links to the society. Otherwise, it might be difficult to argue, for example, for an increasing share of official development assistance, given the current priorities of donor countries.

Contents

I. Introduction

1. At its third session, the United Nations Forum on Forests agreed on the establishment of an Ad Hoc Expert Group on the Finance and Transfer of Environmentally Sound Technologies, and to the convening of a meeting of the Expert Group. The tasks of the Expert Group, to meet in Geneva from 15 to 19 December 2003 with respect to finance are as follows:

(a) To consider previous initiatives on finance, including recommendations from the Croydon, Oslo and Pretoria workshops, as well as the relevant proposals of the Intergovernmental Panel on Forests (IPF)/Intergovernmental Forum on Forests (IFF) for action, background papers and strategy documents of the members of the Collaborative Partnership on Forests;

(b) To assess the role and status of official development assistance (ODA) directed towards sustainable forest management, to consider ways for enhancing its availability and effectiveness, and, in this regard, to identify possible means of enhancing the efforts of developed countries to fulfil their commitments on ODA;

(c) To review the effectiveness of existing international financing for sustainable forest management, including methods and mechanisms, to analyse opportunities, country-level gaps, limitations and donor and recipient priorities, to consider the contribution of the Collaborative Partnership on Forests towards financing sustainable forest management, to propose measures to improve the effectiveness of that financing to enhancing the enabling environment at both the national and international levels and to attract increased financing from all sources;

(d) To explore the potential of new and innovative approaches to attract increased financing for sustainable forest management, to discuss and make suggestions for expanded use of those approaches to address the need for financial resources for financing sustainable forest management, including through national forest programmes or equivalent processes;

(e) To assess country experiences towards the mobilization of financial resources to support sustainable forest management and, in this regard, to identify gaps, potentials and limitations of current financing sources and financial mechanisms to implement sustainable forest management and to propose approaches to enhance and more effectively use and mobilize national and international financial resources;

(f) To assess and consider the role of the private sector in financing sustainable forest management and, in this regard, to recommend measures to improve the enabling environment for private investment in sustainable forest management, at both the national and international levels, and to encourage increased private resource flows to the forest sector, in particular in developing countries and countries with economies in transition.

2. The tasks for the Expert Group are of the utmost importance because of the significant potential of sustainable forest management to contribute to the goals of the international development agenda. In particular, issues such as poverty alleviation, improved food security, access to safe drinking water, affordable energy, changing unsustainable patterns of consumption and production and protecting and managing the natural resource base of economic and social development stress the cross-sectoral implications of sustainable forest management.

3. The present note is prepared to facilitate discussion at the meeting by presenting the evolving global financial framework in general and the status of financing for sustainable forest management in particular. The note aims to draw a picture of the structure of financing of sustainable forest management and to discuss the trends in global development financing in order to find relevant signals that should be taken into account when striving for an enabling environment for sustainable forest management and finding ways to meet the financial requirements for a transition to sustainable forest management. Emphasis is given to the factors that limit the profitability of sustainable forest management, and call for incentives and public sector interventions.

4. The note also describes some critical prerequisites for creating an enabling environment for increased financing, outlines critical market and policy failures and lists outcomes of previous international meetings on those topics. The note pays attention to different financial realities faced by developing countries while recognizing the need for tailoring strategies that make full use of all financial instruments available in any particular country.

5. In reaffirming support to the United Nations Forum on Forests, with the assistance of the members of the Collaborative Partnership on Forests, the Plan of Implementation of the World Summit on Sustainable Development called for immediate action at the national and international levels to promote and facilitate the means to achieve sustainable timber harvesting and to facilitate the provision of financial resources and the transfer and development of environmentally sound technologies, and thereby address unsustainable timber-harvesting practices. It also called for the creation and strengthening of partnerships and international cooperation to facilitate the provision of increased financial resources and the transfer of environmentally sound technologies at all levels to implement sustainable forest management. To this end, the World Summit recognized the importance of accelerating the implementation of the IPF/IFF proposals for action by countries and the members of the Collaborative Partnership on Forests.

6. The International Conference on Financing for Development, held in Monterrey, Mexico, in March 2002, broke new ground for approaching development finance. The Monterrey Consensus recognized that each country had primary responsibility for its own economic and social development, that the role of national policies and development strategies could not be overemphasized, that national development efforts needed to be supported by an enabling international economic environment, and that peace and security were essential for sustainable development (see A/58/216). Any sectoral financial strategy should build on the Monterrey Consensus.

7. Indeed, the substantial financial resources required for achieving sustainable forest management are often beyond the capacity of many developing countries. Historically, developing countries have been highly dependent on international loans and development assistance. Given the realities of the new financial structure, developing countries are increasingly operating with limited loans and an increasing role for foreign direct investments. This requires strong domestic strategic decisions and policy measures if sustainable forest management is to successfully compete for resources in the new financial environment.

8. Even in this new financial environment, the basic questions remain the same. How can existing financial flows to forestry be channelled to sustainable forestry

practices and how can additional investments in sustainable forest management be promoted? Since sustainable forest management is a profit-seeking activity, the question remains how to ensure the profitability and self-financing of sustainable forest management.

9. Sustainable forest management faces the same constraints in domestic and external financing like any other sector in the developing world. Poverty, low level of savings and poor export prices for primary commodities are common constraints to achieving rapid increases in domestic investment rates. External capital is vital, whether it comes in the form of official flows, loans, foreign direct investments or remittances by expatriate nationals.

II. Overview of international processes

10. The United Nations Conference on Environment and Development, meeting in Rio de Janeiro in 1992, adopted Agenda 21[1] and the Forest Principles,[2] which called for "new and additional" financing for developing countries for their efforts and activities related to sustainable development. As a follow-up to the United Nations Conference on Environment and Development, an intergovernmental and participatory policy process was initiated through the ad hoc Intergovernmental Panel on Forests (IPF), 1995-1997, and the ad hoc Intergovernmental Forum on Forests (IFF), 1997-2000. At the recommendation of IFF, the Economic and Social Council established the United Nations Forum on Forests in 2000.

11. IPF strongly emphasized financing. The final report of IPF conveyed the message that current financial resources were insufficient for combating deforestation and promoting sustainable forest management. IPF concluded that while domestic financing should be the main source, external financing, in particular ODA, was vital for developing countries. IPF also raised the issue of growing but unevenly distributed private financing and called for proper valuation of forest resources and development of markets for forest goods and services.

Intergovernmental Forum on Forests process

12. In its final session in 2000, IFF called upon countries to address the special financial needs of, in particular, developing countries and recognized the need for better data on financial flows. The concept of an investment promotion entity emerged from the IFF process. It was proposed in order to mobilize private investments in sustainable forest management by identifying investment opportunities and potential investors, providing information and project support and assisting in risk mitigation. IFF highlighted also the importance of efficient use of existing financing.

United Nations Forum on Forests

13. At its first session, in 2001, the United Nations Forum on Forests established its multi-year programme of work and adopted a plan of action to implement the IPF/IFF proposals for action. The programme of work required that the question of finance be addressed at each session of the United Nations Forum on Forests and that an ad hoc subsidiary body be established to advise the Forum on the issues of finance and transfer of environmentally sound technologies for sustainable forest management.

III. Structure and trends in financing

A. Financial needs for sustainable forest management

14. By definition, sustainable forest management is self-financing. Additional external financing could, however, be justified to cover the incremental costs incurred by forestry operators adopting sustainable practices, to create value for non-market benefits and to counteract those structural incentives that promote unsustainable practices. In many parts of the world unsustainable practices have caused great damage. To reverse these damages and establish sustainable forest management on a permanent basis considerable technical and financial input is needed.

15. There is a lack of common understanding on financial requirements for the worldwide implementation of sustainable forest management. The estimates of the financial requirements in themselves are rare and/or likely outdated. An assessment, which is often quoted, was conducted during the United Nations Conference on Environment and Development. It stated that $31.25 billion would be needed annually for sustainable forest management implemented worldwide. Of that amount, ODA was supposed to contribute 18 per cent, or $5.67 billion. A few years later, the total figure was revised up to $33 billion per year,[3] with capital equipment and infrastructure accounting for 37 per cent, protection of forest services for 18.5 per cent and institutional development and capacity-building for 17 per cent.[4]

16. Those figures have been criticized for neglecting compensation for deforestation and forest degradation. Thus, adding the associated disinvestments, the total required financing should in fact amount to $69.3 billion per year. However, this figure has not been without criticism either. In any case, the calculations refer only up to the year 2000 and thus are probably of limited usefulness to today's policy makers.

B. Structure and trends in financing

Structure of forestry financing

17. Detailed, accurate data on financing of sustainable forest management is non-existent. The figures that are available only refer to the forest sector in general. However, it can still be analysed to reveal the structure and trends of financial flows. There have been attempts to build a picture of financial flows based on secondary sources. One example[5] refers to the year 1993, when, according to an estimate by the Food and Agriculture Organization of the United Nations (FAO),[6] ODA channelled to forestry was $1.54 billion, 7.5 per cent of the total forestry financing. Private domestic and foreign contribution was approximated to amount from $8 billion to 10 billion, consisting largely of investments in plantations and in processing industry.[7] These figures suggest that some $10 billion in public domestic investments was directed to the forestry sector.

18. ODA flows are better documented than the other sources of financing in the forestry sector. Estimates suggest that official flows increased in late 1980s and early 1990s from $1.073 billion, to around $2.2 billion (in 1996 United States dollars) in 1990 and 1992. Since then, up to 1997, to which the data extends, there has been a downward trend. In 1996, forestry ODA was $1.3 billion.[8]

Financing for sustainable forest management in the context of development financing

19. Fresh data on financing of sustainable forest management is scattered and incomplete at best. However, to be meaningful, any financing strategy for sustainable forest management needs to give due consideration to the financial environment in which it will operate. Sustainable forest management may have its own challenges but requirements in forestry financing may not deviate from the general trend in development financing.

20. Financial flows to developing countries have experienced changes in the recent decade. The year 1998 was the turning point in capital flows and saw a new era in development finance. The main developments shaping external financing are decreasing debt stock and increasing private flows, mainly foreign direct investment. ODA flows on the other hand are declining overall, and focuses of the contributing donors are changing. For example, in Africa between 1990 and 2000, official flows to agriculture, forestry and fishing decreased by more than half. At the same time, ODA in education rose by 400 per cent, reflecting the changing strategies and priorities in development financing.[9]

21. The drop in the debt-equity ratio demonstrates that the stock of external debt has fallen while the stock of equity capital owned and controlled by foreigners has risen (see tables 1 and 3). The debt-equity ratio for developing countries as a group dropped from 316 per cent in 1997 to 196 per cent in 2001,[10] however, hiding significant variations from country to country. South Asia has the highest amount of debt relative to equity, having a debt stock six times higher than equities. Sub-Saharan Africa and Europe and Central Asia had a ratio around 300 per cent, while Middle East and North Africa approached 400 per cent in 2001. The lowest share of debt relative to external equity was in East Asia and the Pacific, 134 per cent, to a large extent owing to China, where the external-debt equity ratio was below 50 per cent.

22. This implicates a highly skewed distribution of foreign direct investment (see table 2). Worldwide, the top five countries received 45 per cent of global foreign direct investment inflows in 2001[11] while the share of developing countries together was 28 per cent. In absolute terms the rising trend of foreign direct investment, both in developed and developing countries has been rather strong. A closer look at the UNCTAD statistics on foreign direct investment inflows suggests, however, that the increase in the share of developing countries has not been steady. The annual average during the period 1990-1995 was 33 per cent, rising up to 40 per cent in 1996 and 1997, and then declining to 16 per cent in 2000. However, a positive development in 2001 was that the share of developing countries increased to 28 per cent when the world inflows of foreign direct investment declined by half from the level of the previous year.

23. Among the developing countries there are winners and losers. The top three recipients attracted 53 per cent of the net inward foreign direct investment in 2001.[10] While some countries have been quite successful in attracting foreign direct investment, the share of least developed countries of foreign direct investment in developing countries has declined, from an annual average of 2.3 per cent in the period 1986-1990 to 1.8 per cent in the period 1996-2000.[12] There was also diversity among least developed countries, as 16 such countries received more capital inflows relative to gross fixed capital formation than an average developing country in the

period 1998-2000. Nonetheless, at the global level, the share of least developed countries of total world foreign direct investment flows has remained below 1 per cent.[13]

Differences in the structure of financing between developing countries

24. The aggregate financial figures hide significant variation from country to country and do not reveal the critical differences in the dependency on different sources of financing. In absolute and relative terms Latin America and the Caribbean perform well in attracting foreign investments. They received 40 per cent of the net inward foreign direct investment flowing into developing countries in 2001, while they contributed 31 per cent to the total gross domestic product (GDP) of the developing world. They also hold one third of the total external debt of developing countries. On the other hand, the Middle East and North Africa received 3 per cent of the net inward foreign direct investment while contributing 8 per cent to the developing world's GDP.

25. Despite the increasing role of private equity in development financing, dependence on official flows is still intense, especially in South Asia and Sub-Saharan Africa. While the share of private equity in developing countries as a group exceeded ODA by three times, the ratio of private flows to ODA was about 50 per cent in South Asia. In Sub-Saharan Africa a stunning 90 per cent of external financial flows came from ODA.

Table 1
Selected indicators of external financing in developing countries in 2001
(In billions of United States dollars)

	Net inward foreign direct investment	*Net debt flows*	*Net private flows*	*Net official flows*
East Asia and Pacific	48.9	-12.0	36.4	5.7
Europe and Central Asia	30.1	3.3	30.9	10.2
Latin America and the Caribbean	69.3	11.4	62.8	23.4
Middle East and North Africa	5.5	1.7	8.3	2.0
South Asia	4.1	-0.3	2.9	6.0
Sub-Saharan Africa	13.8	-1.0	11.6	10.2
All developing countries	**171.7**	**3.2**	**152.8**	**57.5**

Source: World Bank, *Global Development Finance-Striving for Stability in Development Finance*, 2003.

Table 2
Percentage share of different regions of selected items in the developing world in 2001

	Net official development assistance	*Net inward foreign direct investment*	*Total external debt*	*Gross domestic product*
East Asia and Pacific	13	28	22	28
Europe and Central Asia	18	18	21	17
Latin America and the Caribbean	10	40	33	31
Middle East and North Africa	8	3	9	8
South Asia	11	2	7	10
Sub-Saharan Africa	24	8	9	6
All developing countries	**100**	**100**	**100**	**100**

Source: World Bank, *Global Development Finance-Striving for Stability in Development Finance*, 2003.

Table 3
External debt-equity ratios and external liabilities (sum of total external debt and foreign direct investment liabilities as a percentage of 2001 gross domestic product)

	Debt-equity ratio (percentage)		*External liabilities (percentage of 2001 gross domestic product)*
	1997	*2001*	
East Asia and Pacific	218	134	65.0
Europe and Central Asia	505	293	66.8
Latin America and the Caribbean	284	162	67.7
Middle East and North Africa	394	371	42.5
South Asia	968	613	30.5
Sub-Saharan Africa	515	303	90.6
All developing countries	**316**	**196**	**61.7**

Source: World Bank, *Global Development Finance-Striving for Stability in Development Finance*, 2003.

26. Apparently, the higher the national income level, the higher the share and absolute quantity of private flows and lower ODA. In 2001, Sub-Saharan Africa received 24 per cent of the net ODA, an amount four times higher than their share of the total GDP of developing countries.

27. Significant changes have occurred in development financing as reflected in the case of least developed countries, although mostly not at pronounced scales. In least developed countries as a group, total ODA was significantly larger than foreign direct investment inflows, with total ODA three times higher than foreign direct investment inflows in the year 2000.[12] Even though ODA remained the largest

component of external finance in the least developed countries, its share declined, both in absolute and relative terms during the second half of the 1990s. The net ODA, bilateral and multilateral in total, declined from $16.8 billion in 1990 to $12.5 billion in 2000.[11] Interestingly, in 28 countries, where ODA decreased, foreign direct investment was on a rising trend. In only four countries was the trend opposite, showing increasing ODA and decreasing foreign direct investment. However, only in seven countries foreign direct investment inflow was more than ODA in 2000, demonstrating the crucial differences in the structure of external financial flows among least developed countries, and by extension developing countries at large.

IV. Elements of a financing strategy for sustainable forest management

A. Enabling environment

28. There are three main challenges facing financing for sustainable forest management: (a) how to increase financing to meet the requirements of transition to sustainable forest management; (b) how to channel the existing financing from unsustainable practices to sustainable ones; and (c) how to make sustainable forest management profitable and lessen the need for additional external financing.

29. It is interesting to raise the question why market mechanisms do not allocate enough financial resources for sustainable forest management. Basically, owing to several policy and market failures, unsustainable practices seem to be more profitable than sustainable forest management and deforestation is more tempting than sustainable resource use and incentives for regeneration can be lacking or inefficient.

30. Furthermore, there are not enough incentives for investments to make sustainable forest management competitive with other sectors and other land uses. Externalities, common access and the public good nature of several forest benefits do not create revenues for the investor and, therefore, do not provide incentives for investments. Inefficient and inadequate rent collection from public forests does not create enough revenue and reinvestments into the sector are inadequate. Finally, although this list is incomplete, the failure of the sector to improve its image and highlight cross-sectional linkages have partly contributed to decreasing ODA flows and to an image of sustainable forest management as a low-profit and high-risk investment opportunity.

31. In the current context of development financing, what are the priority areas of concern, considering the challenges listed above? The structure of financing is moving towards private equity and the profile of sustainable forest management is of the utmost importance when competing for private investment. The decline in ODA would suggest efficient use of the remaining official flows. Both developments reinforce the urgency of measures to increase profitability of sustainable forest management.

32. In financing for sustainable forest management, several direct commercial and concessionary financing mechanisms, market mechanisms and structural mechanisms can be considered. A comprehensive investment strategy for sustainable forest management needs to address all aspects of the forest sector, including production, conservation, plantation and product industries. While production — both raw material production and processing industry — may attract

private investments, in the financing of the global benefits of forests, instruments such the Global Environment Facility (GEF) are of crucial importance.

B. Elements of a favourable investment climate

33. The contribution of foreign direct investment to the gross capital formation and balance of payments are not the only factors favouring foreign direct investment as a financing source. Foreign direct investment is generally regarded as a more stable source of capital than loans, which, in turn, is associated with the risk of increased debt repayments. In addition, foreign direct investment fosters competition and technological externalities and spillovers, which also contribute to dynamic efficiency.

34. Many countries learned lessons from the financial crises in the 1990s, which made the vulnerability to reversals of debt-dependent countries painfully clear. As protective measures, countries have been actively striving to build reserves and create an enabling environment for more stable financial instruments, away from debt towards increasing foreign direct investment .

35. In terms of financing, in addition to conventional challenges forestry has characteristics, which increase the complexity of financing. The long rotation period, which introduces extra risk to the investment, as well as the uneven distribution of costs and revenues over time, are well-known special features of forestry.

36. Forests provide many non-market benefits in particular environmental services at a global scale, for which there is no market of any consequence as yet and, thus, do not produce profit to the direct investor. However, as indicated in a note by the Secretariat on the transfer of environmentally sound technologies, the multilateral pathway of technology transfer being developed through conventions such as the United Nations Framework Convention on Climate Change and its Kyoto Protocol is presenting new opportunities for benefits, such as carbon sequestration.

37. The diversity of the challenges being faced by sustainable forest management calls for coherent and coordinated efforts for investment strategies, which recognize the cross-sectoral implications. This would require a detailed investment framework, where investment strategies for sustainable forest management are included in sectoral plans, including national forest programmes, as well as further mainstreaming of the forest sector in the overall development plans and policies. Legal and policy frameworks need to be developed to define a clear forest policy that would ensure secure and transferable land tenure arrangements with adequate enforcement capacity and involving large multi-stakeholder participation and public-private consultation. Efforts should be made to develop enabling environments that would enhance the domestic private sector investments including local communities in sustainable forest management activities.

38. Given the prevailing financial environment, it is considered urgent to develop mechanisms to facilitate direct private investments, mitigate risks and develop public-private partnerships. Governments have important roles in the facilitation of domestic investments and the channelling of ODA to leverage private investments, which would give encouraging signals to investors.

39. Considering the long-term nature of sustainable forest management investments, the sector can be particularly vulnerable to perceived political risks, such as the degree of stability of political, institutional and legal systems, that an investor could encounter when doing business in a particular country. There is an increased demand from an investor for a rigorous and cross-regional political risk assessment before entering into emerging markets.[14]

40. Property rights are often the first step towards sustainable resource use. Unclear property rights may result in unsustainable short-term profit maximization and increased risks and uncertainties for investors. Insecure ownership does not provide incentives for sustainable use of and investments in the resource. Lack of secure ownership rights also prevents access to capital markets to finance such investments.

41. In addition to foreign direct investment, the emerging portfolio equity flows to developing countries is one of the interesting developments. The best returns in emerging stock markets were yielded by agribusiness and extractive industries in 2001 and 2002. However, the higher rates of returns in developing countries are accompanied by higher risks. Insecurity and weak legal systems impede the growth of emerging stock markets and may increase migration to major exchanges, which, in turn, reduces the liquidity of local markets, thus diminishing the growth potential of local firms.

42. Striving for financing for sustainable forest management is not only competing for private equity. Declining ODA, although not a new trend in itself, raises the urgency of measures to improve the efficiency of the use of current flows. Efficient public-private sector interface, consolidated and efficient systems for absorption of concessionary financing, as well as a functional interface and coordination between policy departments are of importance. Without underestimating the importance of a wide range of other issues, the following two issues may be critical in the prevailing financial environment: (a) increasing the share of financing for sustainable forest management from ODA, or at least maintaining it, requiring a further analysis of donor priorities; and (b) emphasizing the contribution of forests to environment, rural development and poverty alleviation, and the numerous linkages forests have with other sectors of social and economic development.

C. Self-financing sustainable forest management

Creating markets for environmental services

43. It is true that other land uses may offer greater profits and better incentives than sustainable forest management and sometimes, in terms of efficiency, it can be more beneficial for the society to invest in other land uses. This is partly owing to mechanisms that are missing to compensate the environmental and social non-market services to forest owners, which in turn encourage unsustainable practices, hamper financing for sustainable forest management and contribute to deforestation. Also a market for many forest benefits is missing and there is a lack of exclusive ownership rights. Instruments tackling market failures and offering forest owners with incentives to provide watershed protection, recreation, carbon sequestration, among many other non-market benefits, contribute to sustainable forest management, as well as socially more optimal forestry activities.

44. Although the market for non-timber products and services is very small, it is growing and it will be very important to accelerate the development of those that do exist and to further investigate new mechanisms that can efficiently link the buyer and seller of these products and services. In this context, the role of the public sector is crucial for creating legal, policy and institutional frameworks for stable and transferable property rights.

45. Externalities pose two requirements for an efficient revenue collection: valuation of the services as well as developing payment mechanisms and economic incentives to ensure their provision. Although scientific research has been carried out for a long time and methods have been developed dealing with the externalities, several Governments have reported problems with their applications in practice and usefulness in the decision-making process.

46. There has been vital development in market-based instruments for the production and protection of environmental services. It has been reported that there are nearly 300 ongoing cases of actual and/or proposed payments for environmental services. In that regard, in addition to IPF, IFF and the United Nations Forum on Forests, the Kyoto Protocol to the United Nations Framework Convention on Climate Change and the Convention on Biological Diversity manifest the importance of "payments for environmental services from forests" and emphasize the role of forests in carbon sequestration. GEF also provides financing for ecosystem services through its Operational Programme for Integrated Ecosystem Management.

47. From a financial viewpoint, the flexibility mechanisms of the Kyoto Protocol offer promising initiatives. Article 6 of the Protocol allows for joint implementation of emission reduction projects and article 12 allows for project-based carbon offset trading between developing and developed countries under the Clean Development Mechanism.

Improving rent capture

48. In addition to externalities, inefficient rent collection from public forests and inadequate reinvestments adversely affect the financial basis for sustainable forest management. Inadequate rent capture is not a minor issue, as the World Bank has recently estimated that the failure to collect taxes and royalties from legal forest operations amounts to $5 billion worldwide. This is more than three times the ODA channelled to forestry.

49. As discussed in the third session of the United Nations Forum on Forests, inadequate rent capture decreases government revenues, poses a concealed subsidy and increases inefficiency.[15] Among other things, low rent capture may indicate improper accounting of forest resources and incomplete and poor forest valuation. Institutional conditions and market imperfections, such as lack of competition and incomplete information as well as complicated rent collection procedures are issues to scrutinize. Low rent capture is often associated with illegal activities that reinforce forest degradation.

50. Development of an appropriate resource accounting and valuation system has been seen as instrumental in tackling inefficient rent capture. Streamlining rent collection systems using best practices and disseminating reliable information on international prices are also efficient means to support rent collection.

51. It should also be noted that ensuring sufficient financing for sustainable forest management is not only about creating incentives. Perverse subsidies and other disincentives need to be removed as much as incentives need to be put in place. At its second session, the United Nations Forum on Forests invited countries and members of the Collaborative Partnership on Forests to review and report on subsidies that encourage deforestation and forest degradation. In his report on the economic aspects of forests[15] the Secretary-General stated that explicit and implicit perverse subsidies in tropical and temperate forests amount to $14 billion per year. Low stumpage prices owing to inefficient rent collection and trade restriction is a typical example of a concealed subsidy. Explicit subsidies, such as financial support for reforestation, may work against their goals and encourage deforestation if poorly designed. Also, adverse policies in other sectors may have harmful impacts on sustainable forest management, for example providing subsidies to agriculture and reducing the relative profitability of forestry. The effects of agricultural subsidies that contribute to deforestation are well demonstrated.

D. Recommendations of previous international meetings

52. Several initiatives in support of the United Nations Forum on Forests have discussed financing for sustainable forest management. The approaches used and conclusions made in previous meetings are outlined below.[16]

Pretoria

53. The Pretoria workshop (4-7 June 1996, Pretoria, South Africa) provided the first comprehensive assessment of financial needs for implementing sustainable forest management in developing countries, of inventory of sources of finance as well as of innovative mechanisms of financing sustainable forest management. Many of the conclusions of the workshop are still topical and, unfortunately, so are the problems facing the financing of sustainable forest management. The workshop underlined the trend in financial structure, which has been prevalent ever since. Decreasing ODA was noticed with concern and the role of public funding as offsetting risks related to market development and leveraging private investments. When it comes to innovative financial mechanisms, the workshop concluded that the main issue for attracting private sector investments for the forestry sector was not the lack of new financial instruments but channelling the existing investments to sustainable forest management. Public-private partnerships were seen as important for the whole financial environment.

Croydon

54. The workshop in Croydon (11-13 October 1999, Croydon, London, United Kingdom) included both theoretical and business viewpoints and it highlighted many structural obstacles for sustainable forest management. The workshop noted that low profitability of sustainable forestry compared with deforestation and other unsustainable practices was one of the main obstacles for sustainable forest management. As in Pretoria, the need for enhancing public-private partnerships was highlighted. In that regard, the workshop addressed commoditization and internalization of externalities and discussed many market-based instruments.

Oslo

55. The most recent workshop, held in Oslo, from 22 to 25 January 2001, essentially gave room for the private sector's concerns. It elicited several problems facing private sector financing as well as changes needed. The creation of an enabling environment was a characteristic theme for the workshop. The concerns expressed and recommendations made are relevant in the current and envisioned future financial environment. Some of them are even more urgent than at that time, for example the need to link sustainable forest management to current social and human priorities such as poverty eradication. The recommendations concentrated on increasing the profitability of sustainable forest management compared with unsustainable practices, managing risk and reducing transaction costs and encouraging public-private partnerships and greater involvement of private sector in the policy debate.

V. Conclusions

56. **Trends in development financing suggest that sustainable forest management faces a changed financial environment than the one outlined in the context of the United Nations Conference on Environment and Development. Nothing indicates that official flows would reach the required levels in the short or medium term. The primary production sector is one of the hardest hit by the decline in ODA: at about half the previous level. It has been suggested that ODA should be increased considerably, up to 100 per cent in Africa, to enable a level of economic growth that would make a significant reduction in poverty. The reality that ODA is declining needs due consideration when building a strategy for financing sustainable forest management.**

57. **Foreign direct investment on the other hand has been rapidly increasing in developing countries, but is concentrated in a few countries. Those countries receive most of the private financing, while low-income countries are largely dependent on ODA. As a backbone of external financing in low-income countries, ODA remains important for structural adjustment and reducing operational barriers that prevent increasing flows of private financing. Therefore, to attract ODA in the forestry sector, the sector must demonstrate and highlight the contribution of forests to poverty alleviation, the quality and well-being of the environment and other economic and social development issues, which are of priority in donor policies today.**

58. **A stable macroeconomic, institutional and policy environment is a matter of necessity to attract investments. Attempts to ease the debt burden and improve the investment climate have met with successful outcomes in some countries. There remains, however, one major question of whether sufficient financing for sustainable forest management can be secured in this prevailing financial environment.**

59. **The major obstacles facing financing for sustainable forest management can be traced back to the basic problem of market and policy failures that make sustainable forest management unprofitable or not sufficiently profitable. Also, because of perverse fiscal instruments and other incentives, unsustainable practices are more profitable, resulting in deforestation and forest degradation and tying up scarce financial resources. Management practices do not pay off**

in all cases and forestry does not provide as many tempting incentives and profits as some other land uses.

60. **It was suggested that financing strategies should concentrate on improving revenue collection, leveraging private investments and creating stable policy and institutional environments, including secure ownership rights and coherent forest policies towards sustainable forest management. Innovative mechanisms may not be efficient if ownership rights are not secure. Without economic reforms, efforts leveraging foreign investments may not yield results. If the policy environment is insecure and unpredictable, foreign direct investment will remain evasive, even if subsidies or other incentives are present. Many of these necessary prerequisites are beyond the control of the forestry sector. However, in view of the common interest of most sectors, it calls for a holistic approach and recognition of inter-sectoral implications. It is becoming more and more important to link forestry with other sectors in investment and development strategies and to demonstrate the contribution of forests to poverty alleviation, social and economic development and the environment.**

VI. Suggested points for discussions

61. **The Expert Group may wish to consider the following points in its discussion:**

(a) **Official development assistance:**

Ways to use available ODA for the forest sector more effectively in promoting sustainable forest management, encourage donor countries to increase their share of ODA for sustainable forest management, and build national capacities so that developing countries would not need to rely on ODA for sustainable forest management in the long run;

(b) **Private sector funding for sustainable forest management:**

(i) **Opportunities and limitations of the domestic and foreign private sectors in sustainable forest management activities;**

(ii) **Ways to channel the private sector from unsustainable forestry investment into sustainable forest management;**

(iii) **Possible actions to mitigate risks particularly political risks for investments in sustainable forest management in emerging economies;**

(iv) **Measures to improve enabling environment for the increased domestic and foreign private investments in sustainable forest management;**

(v) **Approaches to mobilize community resources to finance sustainable forest management at local levels;**

(c) **Financial mechanisms:**

(i) **Possibilities to enhance the share of funding from the existing global and regional mechanisms and programmes for sustainable forest management (e.g., GEF, Clean Development Mechanism, etc.);**

(ii) **Possible new mechanisms/approaches/policy instruments to improve the investment climate for sustainable forest management;**

(iii) **Creating markets and institutions for the payment for environmental services and non-timber products from forests;**

(d) **Domestic public resources:**

(i) **Ways to mobilize increased financial resources from domestic public sources for sustainable forest management;**

(ii) **Capturing increased rent from forest resources and ensuring adequate investments necessary for sustainable forest management;**

(iii) **Approaches of developing improved national capacities for sustainable forest management, including through transfer of appropriate forest-related environmentally sound technologies, involving aspects such as domestic capacity to choose, apply and further develop imported technologies.**

Notes

[1] *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 corrigendum), resolution 1, annex II.

[2] Ibid., annex III (Non-legally Binding Authoritative Statement of Principles for a Global Consensus on the Management, Conservation and Sustainable Development for All Types of Forests).

[3] Workshop on Financial Mechanisms and Sources of Finance for Sustainable Forestry, Pretoria, June 1996.

[4] C. Chandrasekharan, "Status of financing for sustainable forestry management programmes", in: Proceedings of the Workshop on Financial Mechanisms and Sources of Finance for Sustainable Forestry, Pretoria, June 1996.

[5] P. Moura Costa, J. Salmi, M. Simula and C. Wilson, "Financial mechanisms for sustainable forestry", United Nations Development Programme (UNDP), Programme on Forests, working draft, 1999.

[6] Forest Resources Assessment 1990 — Global Synthesis (FAO Forestry Paper 124), Food and Agriculture Organization of the United Nations (FAO), 1995.

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[8] A. Madhvani, An assessment of data on ODA financial flows in the forest sector, UNDP, Programme on Forests, 1999.

[9] Economic Commission for Africa, *Economic Report on Africa*, 2003.

[10] World Bank, *Global Development Finance — Striving for Stability in Development Finance*, 2003.

[11] UNCTAD, *World Investment Report*, 2002.

[12] UNCTAD, "FDI in least developed countries at a glance", 2002.

[13] UNCTAD, "FDI in least developed countries at a glance", 2001.

[14] Lehman Brothers Eurasia Group Stability Index.

[15] E/CN.18/2003/7.

[16] M. Joshi, "Financing for sustainable forest management: A review of the policy opportunities and challenges", prepared for the Programme on Forests, 2001.