

# Discussion Paper



## Financing Environmental Conservation: Private or Public Investment?

**A** more affluent and certainly larger world population is expected to increase demand for environmental services. With at best a steady supply of such services and more likely a continuing deterioration – the economic relevance of investing to capture 'future' values is clear. Not only environmental economists understand that 'market failure' for 'public goods' is the main challenge. Intervention is required wherever environmentally degrading activities are delivering substantial, private, short-term benefits while the public bears the long-term cost. However, the public resources available for environmental conservation are limited and their allocation across priority areas is likely to be less than optimal. Could market mechanisms in the form of a 'cap and trade' regime enhance efficiency? Can these mechanisms generate much-needed additional investment?

Declining financial resources significantly constrain conservation and sustainable development. Various innovative mechanisms have been developed for financing conservation in recent years. These mechanisms aim to access new revenue sources. Examples include private sector companies through payment schemes, forgiving government debt in return for nature swaps, and new mechanisms for utilizing any available funds, such as conservation trusts.

Private or public sources may provide funding opportunities. Views differ substantially on how private (market-based) and public investment can support payments for environmental services. Public investment approaches usually entail national or supranational governments such as the European Union spending to improve the efficiency of national or regional programs. On the other hand, voluntary and regulatory mechanisms generally characterise private sector investment. Voluntary private investment depends heavily on motivations ranging from philanthropy, enhanced corporate identity, ethical investment and risk management, to maximizing returns from natural assets. 'Cap-and-trade' systems generally require government regulation, enforcement and limits on the resources available for exploitation.

The opportunities can be exhaustively debated with regard to financial institutions using public-private schemes to handle environmental issues in the framework of poverty alleviation and sustainable development. Relating investment approaches to poverty and sustainable development is challenging, involving various stakeholders and complex processes. This session therefore attempted to generate initial discussions and new ideas on:

- (1) What types of public and private investment schemes are possible.
- (2) How various scales of public and private investments can be utilised.
- (3) The scope for the private sector (especially financial institutions) to increase investment in conservation and/or sustainable use of ecosystems.
- (4) What lessons can be drawn from the RUPES ('Rewarding Upland Poor for the Environmental Services they provide) project in Asia.

*"... ecosystems around the world are in decline and will continue to be so unless their value is factored into financial thinking."*

**Jonathan Lash, World Resources Institute  
(Nature 434, 547; 2005)**

Two scales of financial institutions were considered: (1) small-scale programs operating at community level with little capital; and (2) broad-scale operations at national level with large capital. International experience shows there are cases where large financial institutions are capable of taking environmental criteria into consideration in their investment decision-making. In fact, the evidence shows that neglecting environmental issues is linked to high financial risks. The market as such, however, cannot be expected to reward better-than-baseline behaviour. Although enabling policies exist and financial institutions are no longer oblivious to environmental issues, financing conservation generally remains conceptual rather than practical. Three case studies were presented to show the uniqueness of each approach:

- (1) A micro-finance scheme representing a small private investment.
- (2) Sustainable banking representing large- or medium-scale private investment.
- (3) A government policy representing broad-scale public investment, such as Europe's Agri-Environment scheme.

Micro-Financial Institutions (MFI) can play an important role as financial and social intermediaries to create employment opportunities and alleviate poverty. MFIs target small-scale enterprises for farmers who do not have the collateral to access finance to initiate on- or off-farm business activities. Groups of 15-20 people, or even smaller (i.e. five people) can reduce transaction costs, improve social bonding among members, and increase efficiency and group effectiveness. A potential approach for financing conservation efforts would see these groups linked to encourage sound environmental practice in small-scale farm enterprises.

Public concern about environmental issues puts pressure on financial institutions to invest in socially and environmentally friendly businesses. The International Finance Corporation (IFC) reported that the business sector's most important reasons for practising sustainable finance are:

- Increased credibility and reputation.
- Increased value to stakeholders.
- Perceived lower risk and better returns.
- Compliance with international agreements, such as the United Nations Sustainable Development Summit in Johannesburg, South Africa, in June 2002.

It was obvious from the Standard Chartered Group's case study that this banking institution considers its reputation to be its most important asset. Thus the bank focuses on projects with low and well-managed environmental and social risks. Internal direct and indirect risks are the main drivers, rather than external pressures such as environmental and social legislation. These laws are effective only in developed countries; in developing countries such regulations are barely enforced.

On a wider basis, the European Agri-Environment policy pays farmers for a service related to Agri-environmental commitments. Farmers are compensated for the additional implementation costs and any income losses due, for example, to reduced production. This policy aims to reduce environmental risks, preserve nature and cultivated landscapes, and increase biodiversity on farm land. Financed by EU and member states, these measures now cover about 25 percent of agricultural land. Spending on this policy has increased rapidly, accounting for 2 billion Euro or about 4 percent of the EU's 50 billion Euro budget for agriculture in 2003.

Apparently, the suite of financial sources and schemes for environmental conservation is increasing. High awareness and compliance from public and private investors support this positive trend. Nevertheless, none of the financing schemes presented has shown clearly quantified environmental impacts. In other words, many projects fail to quantify their real environmental benefits. Large-scale schemes can suffer from high maintenance costs and it can be difficult to detect and measure changes attributable to the PES (payment for environmental services) undertakings. Small-scale community-based projects seem to solve more localised problems and could channel the benefits to small farmers and enterprises.

It was realised that financing environmental conservation is not an "either-or" case, where one approach works better than the other. The choice of an appropriate scheme is highly contextual, depending on myriad factors. The good thing is that the knowledge and experience gained from

various investment schemes provide a good basis for decision-making on the most appropriate approach in a given situation.

Given the various financing approaches, it is recommended that experiences be shared and promoted between the EU and Asia. Information exchange is important to enrich our understanding of public and private environmental financing. Public and private roles need strengthening to guarantee a wider range of schemes at different levels: local, national, regional and international. Finally, communication between the business community and environmental practitioners is vital to stimulate discussion on innovative, non-conventional approaches to financing environmental conservation.

This discussion paper is based on a session at "The Business Case for Sustainable Development" workshop hosted by the Regional Institute for Environmental Technology (RIET), the International Finance Company (IFC) and the Rewarding Upland Poor for Environmental Services (RUPES) Program. The workshop was part of the Asia Europe Environment Forum 2005, "1/3 of Our Planet: What Can Asia and Europe Do for Sustainable Development?", held in Jakarta in November 23-25, 2005. <<http://env.asef.org>>. For further information, please contact: Beria Leimona, [LBeria@cgiar.org](mailto:LBeria@cgiar.org)



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