

## CHECK AGAINST DELIVERY

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Environmental fiscal reform (EFR) refers to a range of taxation and pricing measures such as taxes on natural resource exploitation or on pollution that can free up economic resources or generate revenues while furthering environmental goals. Additionally, if the reform is appropriately designed, EFR can also have positive effects on poverty reduction. Specific fiscal measures, such as fuel subsidies in Indonesia and Pollution Levy Systems in China, or policy reforms, like the one in the Namibian fisheries sector, have been introduced, resulting in significant additional revenue or cutting the amount of inefficient subsidies.

The value of EFR lies in its **potential to contribute to both objectives at the same time – generate revenues and improve the environment**. However, experience has shown that Environmental Fiscal Reform is not always the most effective way for governments to raise revenue, nor is it necessarily the best approach to protecting the environment. Its effectiveness depends on how the reform is designed and how it has been adjusted to fit the particular framework conditions (among other factors, it depends on the capacities of the institutions to implement such reform). Environmental Fiscal Reform also means challenging coordination among different stakeholders with their diverse interests and needs. Therefore, a firm understanding of the stakeholder arena as well as a soundly oriented negotiation process are necessary to build consensus and foster an endogenous process. Ownership of such processes is far more important to root reforms in a country than any normative academic recommendations will ever be.<sup>1</sup>

Partner ownership can be fostered through Capacity Development. **Capacity Development** can be seen as an endogenous process, strongly led from within the country's capacity. Based on the Paris Declaration on Aid Effectiveness in 2005, Capacity Development has become a major issue on the international cooperation agenda. The emerging consensus about the need for Capacity Development in the international debate is further boosted by an increasing awareness among donors and partners that more money, closer harmonisation and greater use of partner systems do not automatically lead to more development.

Moreover, development progress also depends on how successfully the performance capability of legal and institutional systems can be strengthened and on the extent to which negotiation processes on the partner side can be improved. GTZ understands Capacity Development as a complex learning process. Thus, Capacity Development has a structural, political and institutional dimension, going beyond building the capacity of individuals and organisations.

**In many cases, Capacity Development is needed to design and implement appropriate economic instruments to solve environmental problems in line with local conditions.** Problems of unsustainable resource use – pollution or degradation – often come about as a result of a number of basic governance shortcomings, such as the lack of clearly defined property rights, their open access, or the insufficient enforcement of existing rules. The costs

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<sup>1</sup> GTZ (2005): EFR and National Forest Policies

and benefits of natural resources are not fully balanced. This makes pollution or the degradation of natural resources a far more profitable option and incentives for unsustainable resource use are generated. Environmental Fiscal Reform measures could address this market failure by providing economic incentives to correct the market's shortfall in the management of natural resources and control of pollution. However, certain measures might not be adequately efficient or may even fail, if policy or institutional failures prevail.

Given this backdrop, it is absolutely crucial to understand the underlying governance structure; in other words, the body of rules, enforcement mechanisms and decision-making processes that guide people's behaviour.<sup>2</sup> Knowing the characteristics of the different stakeholder groups impacts significantly on the results of negotiation. One vital question is who stands to win and who stands to lose and how could a more win-win-oriented result be reached. I am sure that we will gain important insights from the different case studies which will be presented over the next two days. The first of the three workshop sessions, the "Special workshop on EFR in Developing, Emerging and Transition Economies" hosted by BMZ and GTZ, will deal particularly with governance issues.

Establishing Environmental Fiscal Reform measures often requires support for complex legal, policy and institutional changes and is therefore directly linked to support for suitable framework conditions. These kinds of structural changes require a complex, overarching political process.

Let me just highlight two issues that have proven vital for the political process:

- First of all, the benefits of establishing Environmental Fiscal Reform measures have to be tangible for the majority of the stakeholders and the design of the measures should be as simple as possible, particularly in the initial phases of the policy cycle in a reform process.
- Secondly, policy changes necessitate ownership on the financial side. The process can be initiated by environmental authorities. However, financial authorities have to be convinced about Environmental Fiscal Reform measures as early as possible. Supporting arguments here include a more stable or larger tax base or greater independence from the labour factor – should additional public income be used to help lower labour costs, as in the case of German Ecological Tax Reform. The rising costs of neglected climate protection pose yet another convincing argument, particularly in countries that are or will be heavily affected by catastrophes due to climate change (Stern review).

Capacity Development supported by donors implies a range of different measures. Due to the important role of civil society – besides the public sphere – donors can help to empower civil society to take on their participation rights (e.g. enhance decision-making competence of resource users). This approach includes getting information out to the stakeholders in a way that is adapted to their capacities and interests and so avoids misconceptions whilst creating a readiness for change. Capacity Development also includes aims to promote enabling policies and legally sound environments, to strengthen institutions, ensure exchanges and the dissemination of information on specific fiscal measures and to establish adapted monitoring mechanisms.

### **Examples of Capacity Development taken from the field**

To illustrate the scope of Environmental Fiscal Reform in the context of development

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<sup>2</sup> GTZ (2004): Natural Resources and Governance: Incentives for Sustainable Resource Use

cooperation, I would like to present examples of Capacity Development on Environmental Fiscal Reform taken from the field.

1. The first scenario is from the forest sector. On behalf of BMZ, GTZ has been active in Nicaragua where it has supported a participative study on the framework, state-of-the-art and future perspectives of Environmental Fiscal Reform in the forest sector there. In parallel, a participatory, multi-stakeholder process on good forest governance, in which the different sectors of society are well represented, has been fostered and a new forest policy — including financing mechanisms — developed. Based on that study and on the process of good forest governance, we aim to work together with the partner country to support the reform of ecological fiscalism in the Nicaraguan forest sector in order to generate positive environmental effects - such as Sustainable Forest Management or a reduction in illegal logging - while gaining positive fiscal benefits through increases in the public revenue basis. Initial modifications of the public tax systems have already been implemented. Among other things, a tax exemption system for investments in forest plantations has been created.<sup>3</sup> A further challenge is the ongoing institutional reform of the forest administration to reduce losses from tax evasion through illegal logging.
2. Another approach aims to provide advantages to enterprises that make steady advances under a cleaner production programme. In Paraguay, a major part of municipal revenue consists of a trade tax, paid by large industries based on their annual turnover. In close cooperation with the State Secretariat of the Environment, the Ministry of Industry and Commerce, and three medium-sized cities, GTZ, on BMZ's behalf, supported the design of an economic instrument that aims to initiate step-wise tax reduction for those industries that implement cleaner production programmes and can actually demonstrate measurable and independently verifiable results, such as emission reduction, pollution minimisation or increased natural resource use efficiency. To implement this instrument, the municipal tributary ordinances need to be modified such that reduced municipal tax income may be offset within the framework of evaluation and verification procedures and related fees. GTZ therefore helped develop a model municipal tributary ordinance. The launch of this tax reduction is accompanied by awareness-raising and by information and training measures for public authorities, industries and independent consultants. Existing interest among different municipalities demonstrates, however, that there is a demand for the model and that the chances of replication are quite good. Apart from the environmental benefits and efficiency gains, the other key elements here include the possibility of compensation for lower municipal tax revenues and the creation of local capacities for environmental management.
3. Urban environmental finance is another working field for GTZ. In the near future, a new component within the Indo-German environment programme ("Advisory Services in Environmental Management - ASEM") will be advising India's Ministry of Urban Development, states and municipalities and the National Urban Renewal Mission in ensuring a sustainable financing of urban environmental infrastructure. In this way, we are helping our Indian partners to achieve their objectives of improved continuity and quality for urban environmental service delivery. This should lead to a reduction in the amount of negative environmental impacts from urbanisation. One particular focus here is on increasing the revenues of Urban Local Bodies, e.g. by raising socially compatible user charges and by improving access to the capital market. Capacity Development here means strengthening the capacity of states and Local Urban Bodies to assess needs, and to design, implement, finance and maintain urban environmental infrastructure to ensure that any potential benefits of new

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<sup>3</sup> Fuchs, Hans et al. (2005): Reforma Tributario Ecológico para el Sector Forestal – Ejemplo Nicaragua, GTZ

investments are sustainable.

However, bringing together environmental finance actors in order to foster dialogue and identify potential is not only important for our partners, but also for the donor community, too. In this context we work on three levels:

- On behalf of the BMZ, we actively foster the exchange of information in the form of conferences and workshops about Environmental Fiscal Reform and other financial instruments and mechanisms such as, for example, the meeting on Environmental Fiscal Reform for Sustainable Development and Poverty Reduction in Berlin in November 2003, which was supported by OECD, UNDP and bilateral donors. Another example here is the 11th PEP Conference with its focus on Payments for environmental services or the Special Seminar on Conservation and Financial Instruments in 2007.
- Moreover, we work on studies related to specific core issues. For instance, in 2005 GTZ issued a study report on Environmental Fiscal Reform and National Forests Policies that provides an overview of the fiscal forestry systems in eighteen countries.
- Additionally, with our pilot project on Environmental Finance GTZ supports knowledge management, advises projects and programmes on how to develop and implement financial instruments, offers training possibilities and works on a manual that is intended to enable policy makers and practitioners to consider financial aspects and address financing gaps through the development and implementation of financing strategy.

## **Conclusions and outlook**

Despite the potential of EFR to yield fiscal, environmental and poverty reduction benefits, it is frequently delayed and constrained by political, social and institutional factors. Therefore, EFR instruments should be thought of as integral components of fiscal and environmental policy combination, not as a “stand-alone” policy package. Capacity Development with its structural, political and institutional dimension could foster Environmental Fiscal Reform. Increasing the amount of financial assistance to developing countries and economies in transition is one important pillar. However, more aid without Capacity Development to go with it will stretch the absorption capacity of individuals, organisations and societies. In this context, we will continue to focus on the development of approaches facilitating the appropriate delivery of external support to Capacity Development in the field of Environmental Fiscal Reform and other market-based instruments.

Thank you very much.