Towards Sustainable International Capital Flows
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# Towards Sustainable International Capital Flows

## Table of Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Executive Summary</td>
<td>3</td>
</tr>
<tr>
<td>Introduction</td>
<td>4</td>
</tr>
<tr>
<td>1 Types of capital flows</td>
<td></td>
</tr>
<tr>
<td>1.1 Official capital flows</td>
<td>5</td>
</tr>
<tr>
<td>1.2 Private capital flows</td>
<td>6</td>
</tr>
<tr>
<td>1.3 Remittance flows</td>
<td>8</td>
</tr>
<tr>
<td>2 Shortcomings of financing mechanisms</td>
<td>9</td>
</tr>
<tr>
<td>2.1 Capital flows in large-scale infrastructure</td>
<td>10</td>
</tr>
<tr>
<td>2.2 Capital flows and climate change</td>
<td>12</td>
</tr>
<tr>
<td>2.3 Capital flows and taxation</td>
<td>16</td>
</tr>
<tr>
<td>3 Visions on the greening of financing mechanisms</td>
<td>17</td>
</tr>
<tr>
<td>4 Innovative financing mechanisms</td>
<td>19</td>
</tr>
<tr>
<td>4.1 Innovative financing mechanisms and infrastructure</td>
<td>19</td>
</tr>
<tr>
<td>4.2 Innovative financing mechanisms and climate change</td>
<td>20</td>
</tr>
<tr>
<td>4.3 Innovative financing mechanisms and taxation</td>
<td>22</td>
</tr>
<tr>
<td>5 Conclusions and recommendations</td>
<td>23</td>
</tr>
</tbody>
</table>
Sustainable development requires finance. But all too often capital flows hinder rather than assist processes of sustainable development. And, while those involved in sustainable development may know about the effects of financial flows they all too often have little knowledge about the underlying mechanisms.

This Briefing Paper draws on the experience of Both ENDS and our partner organisations in three areas (infrastructure investment, financial mechanisms for tackling climate change, and taxation). It examines how financial flows in these areas affect sustainable development. It argues for stronger safeguards on investment and new and innovative investment packages that are more specifically targeted towards promoting sustainable development.
EXECUTIVE SUMMARY

International flows of capital, whether private, public or hybrid, significantly influence efforts at promoting sustainable development. This Briefing Paper examines the influence that these flows have on sustainable development, the mechanisms through which these influences operate and ways in which international financial flows could be brought closer in line with the objectives of sustainable development.

The paper focuses on three areas of financial flows that influence sustainable development: infrastructural investment, financial mechanisms associated with climate change and taxation. While these are not the only areas where finance influences development trajectories, they are among the most important and have been central to the work of Both ENDS and our partner organisations over recent years.

The first section of the report provides a “beginners guide” to financial flows between developed and less developed countries, the flows of private and public funding and the institutional and developmental context in which these occur. The second section identifies some of the major shortcomings in these three flows, in terms of their adequacy, their orientation, their application and their conditionality.

The third section looks at ways of addressing these shortcomings. It suggests two approaches, the first of which is providing adequate safeguards to ensure that development funding does not have adverse or irreversible environmental and social effects that hinder the cause of sustainable development. The second is building innovative financing mechanisms that foster socially and environmentally benign development. These mechanisms can be built at the local, global, private and public levels. The following section discusses some of these mechanisms in more detail and examines how infrastructure investments, climate change mechanisms and taxation issues might be usefully reformed so as to make them more attuned to the imperatives of sustainable development.
INTRODUCTION

The liberalisation of trade, supported by the liberalisation of capital markets, has greatly accelerated in recent decades, in what is widely referred to as the process of ‘globalisation’. Economists often present the expansion of capital markets and increased financial integration as instrumental, if not essential, for sustained economic growth. Trade in raw materials, goods and services is intensifying and expanding to increasingly remote areas, gradually incorporating them into the world economy. Globalisation offers opportunities to strengthen international cooperation over sustainable development, but experience teaches that ill-conceived investments also seriously undermine the scope for sustainability.

The recent crisis in the American mortgage market has affected financial markets around the globe. The increasingly virtual capital markets appear to be more vulnerable to unexpected shocks and crises of confidence and have a greater potential to pose serious risks to the economic reality. This Briefing Paper explores the effects, both positive and negative that international capital flows have upon efforts to enhance sustainable development.

This report also focuses on the lack of attention paid to ecological and social sustainability within existing financing mechanisms and outlines visions for the greening of these financing mechanisms. It presents ideas on how innovative financing mechanisms could be developed that would generate capital flows for sustainable development and environmental protection. Generally, social and environmental organisations have limited expertise in the field of finance. Yet it is quite evident that financial issues play a strong role in influencing efforts at promoting sustainable development. This Briefing Paper is in no way exhaustive, but reflects on, and draws upon experiences from, three areas where Both ENDS and our partners have been recently engaged in: infrastructure, climate change and taxation.

The first chapter of this paper provides an overview of the major types of international capital flows within the world today. The second chapter lists the shortcomings in these financing mechanisms in terms of ecological and social sustainability. The third chapter presents an outline of the visions emerging from our work with CSOs on greening these financing mechanisms. The fourth chapter presents proposals for developing innovative financing mechanisms that could generate capital flows for sustainable development and environmental protection. Finally, the fifth chapter draws out a set of provisional conclusions and policy recommendations.

We hope that this Briefing Paper will encourage others; in whatever field they work, to reflect on the significance of capital flows in their efforts to promote sustainable development.
1 TYPES OF CAPITAL FLOWS

Every day, billions of dollars, euros and many other currencies flow around the world. Such transactions are structured in many different ways, using various financing mechanisms, including loans, investments, derivatives, etc. One practical way of classifying these international capital flows is by distinguishing them by source of origin. These are set out below:

1 Official capital flows: These flows originate from government agencies and can be categorised as:
   • Official Development Assistance (ODA) aid flows from member states of the Development Assistance Committee (DAC) of the Organisation for Economic Cooperation and Development (OECD) to developing countries.
   • Other Official Flows (OOF) aid flows that do not meet the criteria set for ODA, either because they are not primarily aimed at development, or because they have a grant element of less than 25 per cent (e.g. officially supported export credits).

2 Private capital flows: These flows originate from the private sector (e.g., banks, TNCs, investment funds, private grant-makers) and include foreign direct investments (FDI), portfolio investments, lending, securities, bond transactions, commercial export credits and grants.

3 Remittance flows: These flows originate from private citizens (migrants) and money transfer agencies (micro-financial institutions, ranging from informal to quite formal) transferring money to their home countries.

The majority of capital flows around the world are private capital flows. Most of these are transactions between industrialised countries, generally bypassing developing countries, particularly in Africa. In light of our interest in poverty alleviation and sustainable development this Briefing Paper concentrates on capital flowing between industrialised and developing countries (see table 1).

| TABLE 1 NET CAPITAL FLOWS FROM OECD-DAC COUNTRIES (MILLION US$) |
|--------------------------|------------------|------------------|
|                          | 2005             | 2006             |
| **Official capital flows** |                  |                  |
| » ODA                    | 107,099          | 104,421          |
| » OOF                    | 1,430            | -9,774           |
| **Private capital flows** |                  |                  |
| » Private flows at market terms | 179,559          | 194,779          |
| » Net grants by NGOs     | 14,712           | 14,648           |
| **Remittance flows**     |                  |                  |
| » Developing countries   | 188,769          | 207,528          |

Source: OECD / World Bank
The figures in Table 1 show that for developing countries remittances are a very substantial source of finance, more important than aid flows or even investment flows from the private sector. They are also increasing faster than flows within all other sectors. Foreign direct investments (FDI) and portfolio investments are rising although they are generally only significant in a fairly limited number of developing countries, particularly in Asia and Latin America.

Another changing feature in the landscape of capital flows is the rapid increase in flows from private foundations and charities. The grant of US$ 1 billion that Mr. Ted Turner - founder of the CNN broadcasting company – donated in 1997 to the United Nations is a good example. It is notable that that the budget of the Bill & Melinda Gates Foundation – currently US$ 34.6 billion – now surpasses the annual ODA budget of the USA, which amounted to US$ 27.6 billion in 2005.

The public is fairly familiar with the fact that developing countries receive substantial inflows of capital, but it is less widely known that at the same time very significant amounts of capital are also exported out of many developing countries (see Table 2).

The United States receives, or borrows, a large part of the savings of the rest of the world. An increasing number of transnational corporations (TNCs) with their origins in developing countries invest in industrialised countries, as do a growing number of sovereign state-owned investment funds. The most important capital exporting countries are concentrated in Asia and the Middle East, but the number of developing countries with current account surpluses that may be invested abroad has been increasing.

Table 2 shows that the outflows of capital from developing countries to the rest of the world substantially exceed the inflows and this suggests that a large part of the surpluses generated in developing countries is being invested in the industrialised world, rather than in domestic efforts for sustainable development. Poverty alleviation and sustainable development in the developing world require that this trend should be reversed, with renewed emphasis placed on promoting domestic investments.

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<tr>
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<th>IN</th>
<th>OUT</th>
<th>DIFFERENCE</th>
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<tbody>
<tr>
<td>Unites States</td>
<td>1,212,200</td>
<td>426,800</td>
<td>785,400</td>
</tr>
<tr>
<td>Japan</td>
<td>232,300</td>
<td>370,800</td>
<td>-138,500</td>
</tr>
<tr>
<td>Unites Kingdom</td>
<td>1,364,400</td>
<td>1,305,600</td>
<td>58,800</td>
</tr>
<tr>
<td>Euro area</td>
<td>1,643,900</td>
<td>1,523,200</td>
<td>120,700</td>
</tr>
<tr>
<td>Emerging Markets and Developing Countries</td>
<td>716,400</td>
<td>1,174,400</td>
<td>-458,000</td>
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</table>

1.1 OFFICIAL CAPITAL FLOWS

In October 1970, the UN General Assembly adopted Resolution 2626, in which developed countries agreed to increase their resource flows to developing countries to a level equivalent to 1% of their GNP. The same resolution also contained the target of developed countries setting aside a minimum of 0.7% of their GNP for Official Development Assistance (ODA) by 1975. Until now, only a few countries (Denmark, Luxemburg, the Netherlands, Norway and Sweden) have met this pledge. The average contribution from DAC (Development Assistance Committee) member states in 2006 was estimated as 0.46%. Taking into account the money spent that year on debt cancellation (US$ 19,175 million) the level of regular ODA spent by DAC member states declined by 1.8% in 2006.

The bulk of the official capital flowing to developing countries is moved through bilateral channels and agencies. While some countries channel more than half of their ODA via multilateral channels (e.g. Italy) most countries use this channel substantially less. On average in 2005 some 23% of the total ODA contributions of DAC member states were disbursed via multilateral organisations (table 3).

Most ODA contributions are grants and only account for some of the aid transactions that are financed. Especially in the case of loans, relatively limited ODA grants can facilitate lending at concessionary rates. Most of the lending of multilateral development banks is concessionary, i.e. against lower interest rates and longer repayment terms. ODA contributions to the multilateral development banks give these institutions additional leverage contribute to their exceptionally powerful position and generally marginalise the bilateral agencies.

Most UN agencies provide targeted financing to developing countries which is tied to specific needs and sectors. Multilateral development banks
have a much wider scope and impact and also channel much larger amounts of money. Their policies tend to set the standard for development policies followed by many bilateral donors. Given this the policies that drive the aid disbursed via multilateral channels attracts much more attention and is more important than the policies behind the aid channelled via bilateral agencies.

One key area of attention is the conditions that are attached to multilateral aid programmes. These “conditionalities” attached to aid take a wide range of forms. One that is widely used and widely criticised is the requirement to implement certain kinds of macro-economic policies, usually including programmes to privatise the service sector and liberalise trade. Other conditionalities that are frequently applied include requirements relating to governance, transparency and corruption. Over the past 20 years a vast body of policies intended to safeguard the environment have also been developed to avoid aid programmes having unnecessary negative environmental impacts.

There is general consensus that ODA and other aid money should not be abused. Most of the debates about the conditionalities to aid do not challenge this point, but originate from the apparent incoherence between the different types of conditionalities imposed. There are also unresolved questions over who is accountable for the negative impacts or failure of aid-financed activities.

Not all official capital flows to developing countries are primarily aimed at promoting development, nor do they necessarily contain a grant element of at least 25%. Official capital flows that do not meet these criteria are

<table>
<thead>
<tr>
<th>Table 3</th>
<th>ODA FROM DAC COUNTRIES TO MULTILATERAL ORGANISATIONS IN 2005(^5) (MILLION US$)</th>
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<tbody>
<tr>
<td>World Bank Group</td>
<td>5,213</td>
</tr>
<tr>
<td>» IDA</td>
<td>4,823</td>
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<td>Regional Development Banks</td>
<td>2,085</td>
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<tr>
<td>» AfDB</td>
<td>1,088</td>
</tr>
<tr>
<td>» ADB</td>
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<td>» IADB</td>
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<td>UN agencies</td>
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<td>108</td>
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<tr>
<td>» UNDP</td>
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<tr>
<td>» WFP</td>
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<tr>
<td>» UNICEF</td>
<td>717</td>
</tr>
<tr>
<td>» UNHCR</td>
<td>386</td>
</tr>
<tr>
<td>European Commission</td>
<td>9,216</td>
</tr>
<tr>
<td>» EDF</td>
<td>3,029</td>
</tr>
<tr>
<td>Other Multilateral</td>
<td>2,677</td>
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<tr>
<td>» IMF</td>
<td>81</td>
</tr>
<tr>
<td>TOTAL Multilateral</td>
<td>24,644</td>
</tr>
<tr>
<td>Total Bilateral</td>
<td>82,133</td>
</tr>
<tr>
<td>Total ODA</td>
<td>106,777</td>
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</tbody>
</table>

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6. This aggregate includes the groups of Other Emerging Market and Developing Countries defined in the World Economic Outlook, together with Hong Kong SAR, Israel, Korea, Singapore, and Taiwan.
8. Net official development assistance in 2006; preliminary data; OECD, 3 April 2007
classified as Other Official Flows (OOF). Examples of OOF disbursements are loans, guarantees or insurances provided by the government-supported Export Credit Agencies (ECAs) of industrialised nations. Most military aid to developing countries is also recorded as OOF. In recent years there have been efforts to expand the criteria for ODA in order to allow more OOF expenses to be administrated as ODA\(^1\). Aware of the need to guard the integrity of the ODA definition, the OECD-DAC has not yet agreed to the majority of these demands. With increasing official capital flows from emerging market countries outside the OECD – e.g., Brazil, India, Russia and China – discussions on the distinction between ODA and OOF are likely to continue.

1.2
PRIVATE CAPITAL FLOWS

Private capital flows to developing countries originate from commercial banks, internationally operating corporations, private funds, as well as private / non-governmental granting agencies, such as foundations. While private donor agencies provide substantial amounts of money in grants, by far the bulk of private capital flows consists of lending and, more importantly, investments. Investments can be differentiated into two categories. Foreign direct investments (FDI) refer to companies investing capital abroad to acquire assets with the aim of operating these facilities. FDI has a medium and long-term focus. Portfolio investments involve the acquisition of foreign securities such as stocks and bonds. Here the aim is to actively manage or control the foreign entities that issue these securities in order to achieve maximum returns on invested capital. Portfolio investments generally have a short-term scope and are therefore much more volatile.

In line with neo-liberal economic thinking, deliberate efforts have been undertaken to liberalise investments and capital markets. In many cases the implementation of such policies, in combination with privatisation programmes, has been a mandatory part of the conditionalties to ODA provided by most multilateral and bilateral aid agencies. The rationale is that under market conditions the private sector operates more efficiently than public sector ventures. It is thought that increasing profits in the private sector contribute to economic growth and ultimately benefit overall welfare. However, unlike official capital flows, where no direct returns are expected, most private capital flows to developing countries and emerging markets are expected to deliver significant financial returns to the investor. These returns make up a large amount of the capital outflows from these regions (see table 2) which often greatly exceed capital inflows. Between 1995 and 2005 these outflows increased far more rapidly than the inflows (figure 1).

Many civil society and public sector organisations have sought to draw attention to this trend as well as the other negative impacts of this policy framework. Persistent calls have been made for the regulation, rather than the liberalisation of investments and other private capital flows. A prime concern is that returns on investments should stay in host countries so as to contribute to local sustainable development. Other concerns are being voiced about the privatisation of public services and the erosive effect on democratic accountability and the affordability of such services.

As with official capital flows, private capital flows can also often have negative social and environmental impacts and also require safeguard policies. In addition to legislation, governments can use subsidies and taxes as instruments of regulation. Many companies themselves acknowledge a responsibility for the social and environmental impacts of their business, which is referred to as Corporate Social Responsibility (CSR).

Goverments tend to encourage the private sector to voluntarily adopt the principles of CSR\(^12\), and to take environmental and social impacts into consideration throughout the production chain. Equivalent initiatives have also been pioneered in the financial sector by institutions such as commercial banks, insurance companies or pension funds. The UNEP has established a partnership with more than 160 private financial institutions under the name of the UNEP Finance Initiative\(^13\). This initiative aims to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institutions’ operations. Both banks and insurance companies are involved and the initiative’s activities concentrate on research, training and the exchange of experiences. The Equator Principles\(^14\) are a further example of self-regulation through voluntary guidelines on environmental and social issues in project financing that more than 50 commercial banks subscribe to.

In addition to efforts to mainstream principles of CSR in financial operations, there are also some private financial institutions and banks that solely concentrate on financing sustainable development efforts. Such niche-market institutions are often referred to as ethical institutions\(^15\). They generally seek close cooperation with civil society organisations and aim to be pioneers in advancing sustainable development. They practice high levels of transparency, their profit margins tend to be narrower and they often provide a limited set of financial services (e.g., microfinance). These ethical institutions provide useful benchmarks for the more mainstream private financial institutions.
1.3

REMITTANCE FLOWS

Remittance flows originate from private citizens\textsuperscript{16} and money transfer agencies\textsuperscript{17}, which transfer money on behalf of migrants to their home countries. Remittance flows surpassed ODA in 1995, and have steeply increased since then (see table 1). Until recently not much attention has been paid to these remittances. Their growing importance might challenge the common assumption that poor people are excluded from capital markets, and lack access to finance. However, more research in this field is required to answer this question.\textsuperscript{18}

\textsuperscript{10} The former Dutch coalition government of 2003 sought to include expenses for peace-keeping operations and for the Clean Development Mechanism (CDM) of the Kyoto Protocol under the ODA definition (Regeerakkoord, 16 May 2003).

\textsuperscript{11} The Global Financial Stability Report, IMF, April 2007, table 1

\textsuperscript{12} The OECD Guidelines for Multinational Enterprises, http://www.oecd.org/daf/investment/guidelines

\textsuperscript{13} http://www.unepfi.org/

\textsuperscript{14} http://www.equator-principles.com/

\textsuperscript{15} Examples include the Triodos Bank (NL) and the Co-operative Bank (UK).

\textsuperscript{16} Mostly migrant workers.

\textsuperscript{17} i.e. micro-finance institutions, ranging from informal to quite formal.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure1}
\caption{Capital inflows and outflows: emerging markets and developing countries (billion US$)}
\end{figure}
2 SHORTCOMINGS OF FINANCING MECHANISMS

While various types of capital flows are analytically distinguished according to their origin, combinations of these different flows and different mechanisms are more common. The role of private capital in relation to funds managed by Multilateral Development Banks (MDBs) is definitely expanding. Private foreign direct investments are often facilitated by official government supported export credits provided through Export Credit Agencies (ECAs). Where least developed countries are concerned, such investments may also receive some ODA grant-support. ODA grants also are regularly provided to subsidise private lending for transactions that have a development objective. A substantial part of ODA grants and loans is provided to encourage FDI as a key to promote economic growth and in the end sustainable development. From the perspective of sustainable development, however, many financing mechanisms have serious limitations, irrespective of the types of capital flows involved. This is best illustrated by looking at trends in some specific sectors.

2.1 CAPITAL FLOWS IN LARGE-SCALE INFRASTRUCTURE

The existence of functional infrastructure is generally seen as vital for economic growth. In many developing countries much capital has been invested in infrastructure that facilitates the export of primary products and (natural) resources. The revenues from these exports often end up in the hands of small but politically and economically powerful elites. In many cases the local communities hardly receive any benefits, yet are obliged to cope with serious negative environmental impacts that threaten their local resource base and livelihoods. The term ‘resource curse’ is often used describe this phenomenon, especially in the context of oil and gas projects. Many investments in infrastructure development lead to serious damage to the natural environment and increase the gap between the poor and the rich.

In the coming decade, it is likely that many billions of Euros will be invested by multilateral development banks in transport, energy and water projects in all the regions of the developing world. Justification for these investments tends to be based on promoting regional economic integration and opening markets to the poor. The renewed focus of multilateral development banks on infrastructure development is often characterised as a new ‘high risk, high reward approach’. Many of the projects that are emerging appear to be re-packaged versions of initiatives designed in the 1970s and 1980s.

Examples of this include:

- Initiative for the Integration of Regional Infrastructure in South America (IIRSA)
- Inter Linking of Rivers Project in South Asia (ILRP)
- Greater Mekong Sub-region Programme (GMS)

All these projects seek to link rivers and to divert water away from its natural flow often to feed agricultural or industrial demand for water elsewhere. While multilateral development banks continue to play an important role in infrastructure development programmes, the role of ECAs and private capital in the financing of such infrastructure development is also clearly expanding. This realignment of financial institutions aiming to maximise economic growth poses new challenges to civil society and development agencies as they try to ensure environmentally and socially sustainable outcomes from new infrastructure programmes.

Regardless of the particular sponsors, the host country/region, or the financing institutions involved, large-scale infrastructure development activities share some common features. In the first place, these activities are often driven by new external demands from expanding regional (in the case of some large countries) national or global markets. The booming economy of China is often mentioned as a significant factor in boosting the demand for natural resources. In the energy sector an increasing scramble for new oil and gas fields or for biomass supplies can be seen from the European Union and other industrialised countries.

Secondly, infrastructure development is normally driven by powerful alliances of public and/or private investors, overruling input from other interested or affected parties. In centrally planned economies the state will also play a more prominent role. A dominant theme used when
legitimising investments is that the individual interests of local stakeholders are subordinate to the wider public interests served by infrastructure projects, a seemingly logical if regrettable trade-off. A third feature is that many infrastructure projects are built in remote rural areas inhabited by vulnerable communities that depend on a subsistence economy. These communities usually lose control over the natural resources that they depend on for their living. Such situations have sometimes led to the mobilisation of significant social movements involving national and international civil society organisations, labour and environmental organisations, technical experts and politicians. A fourth feature of these projects is that they often invoke a substantial polarisation between proponents and opponents. These large-scale infrastructure projects also often lead to reallocations and distortions in public finance budgets in other sectors causing additional conflicts within the public sector.

Governments themselves often contribute to such polarisation by aligning themselves with the project proponents. The many campaigns over such projects in the past have led most financing agencies to require that environmental studies are carried out so they meet part of their due diligence efforts. In many cases project sponsors are required to carry out Environmental Impact Assessments (EIAs) prior to implementing a project. However these studies are often carried out by technical experts who are closely allied with the project sponsors. As a consequence, these formal studies regularly fail to anticipate the extent and scope of environmental damage and social impacts. Even if such studies are done correctly from a technical point of view, the affected communities often find it difficult to understand such studies or participate in them due to the technical language and idioms used.

Frequently public access to review such documents remains restricted and, when shortcomings are identified, the need for the project to be completed for the sake of national economic development often overrides upholding the fundamental social and environmental rights of the affected communities. Hence a well-organised and effective civil society is of utmost importance for ensuring socially and environmentally sustainable infrastructure development. Given that individual infrastructure projects are increasingly linked up in broader national or regional development strategies, there is a growing need for civil society organisations to build alliances and networks with partners in other localities. Experience of effective analytical and advocacy work in combination with public campaigning from one project can significantly strengthen the ability of communities elsewhere to reshape projects and change the balance of costs and benefits. Effective campaigns generally combine protest actions with critical engagement in policy development and the assessment of the processes of governments, project developers and financial institutions.

Much effort goes into ensuring that financial institutions comply with the social and environmental safeguard policies that they are obliged to follow. Such work is important but can be quite frustrating, since it tends to deliver rather limited visible effects on the ground. At the same time, project developers and their financiers are rarely prepared to seriously consider alternative plans and proposals put forward by local communities and their representatives.

It is potentially more effective (but not necessarily any less frustrating) to attempt to analyse and explain the economic and financial implications of infrastructure development projects. Such analysis can be used to identify whether environmental costs as well as mitigation plans for social impacts
(e.g., resettlement schemes) are fully taken into account in the financial planning of these programmes. Evidence that such costs have not been taken on board may cause investors and other financiers of infrastructure projects to request fundamental reviews of the initial plans. Analysis of the way in which sub-contracts for infrastructure programmes are awarded can also provide important insights into who benefits from such projects. Often the transparency of the financial mechanisms behind infrastructure development programmes is quite limited. Such forms of analysis require significant economic (in the first case) or technical financial expertise (in the second case) to be able to identify the costs and benefits and the complex arrangements involved in putting large and complex programmes together. Reliance on technical expertise can all too easily become a mode of exclusion and a barrier for local communities to provide inputs into infrastructure projects, based on their own detailed knowledge of the local environment.

2.2

CAPITAL FLOWS AND CLIMATE CHANGE

Climate change poses tremendous challenges that affect the fundamentals of people’s lives around the world in terms of food production, access to water, public health and major changes in the natural environment. The livelihoods of hundreds of millions of people are currently at stake. There is a general consensus that the financial burden of coping with the impacts of climate change will increase substantially before action is taken, despite strong calls for early action to ensure that the costs of climate change remain manageable. A British government commissioned report – the Stern Review – estimated that effective action to address climate change at the global level will require an annual expenditure of about US$ 500 billion (1% of global GDP). Financing on this level for climate change is certainly not yet available.

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STERN REVIEW: The Economics of Climate Change

In 2005 the British Treasury commissioned Sir Nicholas Stern, a former chief economist of the World Bank, to make an assessment of the costs involved in managing climate change. A comprehensive report was published in October 2006. It concludes that if we do not act, the overall costs and risks of climate change will be equivalent to losing at least 5% of global GDP each year, now and forever. If a wider range of risks and impacts is taken into account, the estimates of damage could rise to 20% of GDP or more. In contrast, the costs of action – reducing greenhouse gas emissions to avoid the worst impacts of climate change - can be limited to around 1% of global GDP each year.

Based on global GDP data for 2006, the estimates of the Stern Review translates in the following figures:

- **Annual direct costs of no action**: US$ 2,412,244 million (5%)
- **Annual direct and indirect costs of no action**: US$ 9,648,976 million (20%)
- **Annual costs of action**: US$ 482,449 million (1%)

In 2007 climate change ascended to the top of the international environmental agenda. In a series of recent reports, the Intergovernmental Panel on Climate Change (IPCC) of the UN established that serious climate change is already well underway and that this is largely due to human activities. These reports also underline that many poor people in developing countries are particularly vulnerable to the impacts of climate change. At the end of 2007 all the member countries of the UN Framework Convention on Climate Change (UNFCCC) agreed to start negotiations on an international agreement that needs to succeed the Kyoto Protocol, which expires by the end of 2012.

The Kyoto Protocol was adopted in Kyoto (Japan) in December 1997 during the Conference of Parties (COP) of the UNFCCC. It entered into force on 16 February 2005, after it was ratified by Russia. The only remaining country with substantial emissions that has not ratified this agreement is the USA. The Kyoto Protocol requires industrialised countries to reduce their greenhouse gas emissions by at least 5% below their 1990 emission levels. It allows for the use of so-called flexible mechanisms that enable participating countries to reduce emissions as efficiently and cost effectively as possible through market-based initiatives.

To date very few industrialised countries have reduced their domestic greenhouse gas emissions to 1990 levels. To meet their Kyoto commitments these countries therefore need to buy emission reductions from abroad and the CDM is proving to be the key mechanism for this. Towards the end of 2007, close to 3000 projects were in the CDM pipeline, while far fewer projects were in the JI pipeline.
Flexible instruments of Kyoto Protocol:

- **Clean Development Mechanism (CDM)**, through which industrialised countries invest in projects in developing countries that contribute to sustainable development and the reduction of greenhouse gas emissions, in exchange for Certified Emission Rights (CERs).
- **Joint Implementation (JI)**, through which nations that both have reduction targets can assist each other in emission reduction investments in exchange for Emission Reduction Units (ERUs)\(^28\).
- **International emission trading**, in which countries that have a shortage of emission rights can buy these from nations that have an excess.
- **Activities implemented jointly**, which includes all voluntary activities for climate change mitigation that would otherwise not occur.

### CDM and JI Pipeline per 1 November 2007\(^29\)

<table>
<thead>
<tr>
<th></th>
<th>CDM</th>
<th>JI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total number of projects</td>
<td>2,701</td>
<td>197</td>
</tr>
<tr>
<td>- registered</td>
<td>827</td>
<td>1</td>
</tr>
<tr>
<td>- in process of registration</td>
<td>154</td>
<td>1</td>
</tr>
<tr>
<td>- at validation (CDM) / at determination (JI)</td>
<td>1,666</td>
<td>195</td>
</tr>
<tr>
<td>Total amount of CERs / ERUs expected from projects in pipeline by 2012</td>
<td>2,288,000,000 (~2,288 Mton)</td>
<td>207,000,000 (~207 Mton)</td>
</tr>
</tbody>
</table>

As with other market-based mechanisms, the price of emission reductions depends largely on the interaction of demand and supply and, like any other market, prices may fluctuate sharply. The price of a CER currently fluctuates around €16. Some contracts, especially those from the very early days of the CDM were concluded for much lower prices, while today the price can be higher. This is particularly the case for CDM projects that involve technological innovation for cleaner production methods and for those projects that have a clearly defined sustainable development objective. Based on the current average price of €16 per CER, the total value of the pipeline of CDM projects is approaching some €40 billion. This new market is likely to expand considerably before the end of the Kyoto Protocol in 2012.

As many countries seem set to pursue emission markets beyond 2012, significant capital flows to developing countries are likely to continue in return for these countries assisting industrialised ones in meeting emission reduction targets. In addition to the official emission (or carbon) market under the Kyoto Protocol, there is also a growing voluntary carbon triggered by the initiatives of citizens and companies who wish to compensate for the greenhouse gas emissions for which

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\(^25\)[http://www.hm-treasury.gov.uk/independent_reviews/stern_review_economics_climate_change/stern_review_report.cfm]


\(^27\)[The following gases are considered as greenhouse gases: carbon dioxide (CO2), methane (CH4), nitrous oxide (N2O), hydrofluorocarbons (HFCs), perfluorocarbons (PFCs) and sulphur hexafluoride (SF6).]

\(^28\)[CERs under CDM and ERUs under JI are both equal to the reduction of one metric ton of CO2 equivalent.]

\(^29\)[UNEP Risø Centre, 1 November 2007; http://cdmpipeline.org/]

they are responsible. The exact size of this voluntary market is hard to assess, but estimates put it well above the 100 M ton CO2 equivalent\textsuperscript{30}. The price of voluntary emission reductions (VERs) in this market is currently around € 25 per ton, resulting in an additional market of at least € 2.5 billion.

While the voluntary carbon market is less well regulated, the CDM market is meant to contribute to sustainable development. Governments of host countries for CDM projects may freely decide how this should be realised. However current assessments indicate that the CDM is not significantly contributing to sustainable development\textsuperscript{31}. Moreover, CDM appears to be driven by similar forces as other FDI related capital flows leading most CDM investments to be concentrated in emerging markets. The countries that have attracted the most CDM funding are China (32%) and India (29%), followed by Latin America (23%) with sub-Saharan Africa (1.3%) hardly benefiting at all.

Another shortcoming of CDM is that only limited investments are being directed to activities that support developing countries in their efforts to decarbonise their economies. As illustrated in the below table, nearly one third of all CERs are derived from HFCs and other potent greenhouse gas reduction projects, and these only make up 2% of the total project portfolio. Avoiding emitting such gases, in particular HFC-23 is technically feasible with relatively little investment and by including such projects in the CDM it has become possible to generate substantial extra profit due to the large number of CERs that can be derived from these projects. Each avoided ton of HFC-23 emissions generates 11,700 CERs. Though less profitable, many landfill and other methane reduction projects attract similar criticisms. While the number of renewable energy projects financed under the CDM seems quite high, most CDM investments are directed towards projects such as biomass, hydropower or wind energy that make little contribution to much-needed technological innovation.

The protocol of CDM projects dictates that it must be established that the emission reductions that they generate would not have happened without the CDM investment. This so-called additionality of CDM projects is a key requirement, as otherwise CERs generated under the CDM would allow for additional emissions of greenhouse gases and have the opposite effect of the objectives of the Kyoto Protocol. Yet the CDM is often criticised for not strictly assessing the additionality of projects, leaving serious doubts about the overall effectiveness of the Kyoto Protocol\textsuperscript{33}.

<table>
<thead>
<tr>
<th>CDM PROJECTS BY SECTOR\textsuperscript{32}</th>
<th>NUMBER OF PROJECTS (% OF TOTAL)</th>
<th>CERS BY 2012 (% OF TOTAL)</th>
</tr>
</thead>
<tbody>
<tr>
<td>HFCs, PFCs &amp; N2O reduction</td>
<td>2 %</td>
<td>33 %</td>
</tr>
<tr>
<td>Renewables</td>
<td>61 %</td>
<td>28 %</td>
</tr>
<tr>
<td>CH4 (methane) reduction &amp; cement &amp; coal mine/bed</td>
<td>18 %</td>
<td>20 %</td>
</tr>
<tr>
<td>Supply-side energy efficiency</td>
<td>11 %</td>
<td>10 %</td>
</tr>
<tr>
<td>Fuel switch</td>
<td>3.2%</td>
<td>7.1%</td>
</tr>
<tr>
<td>Demand-side energy efficiency</td>
<td>4.6%</td>
<td>1.0%</td>
</tr>
<tr>
<td>Afforestation &amp; reforestation</td>
<td>0.5%</td>
<td>0.3%</td>
</tr>
<tr>
<td>Transport</td>
<td>0.3%</td>
<td>0.2%</td>
</tr>
</tbody>
</table>
The Xiaogushan Hydropower Project ("XHP") is a run-of-river hydro project located on the Heihe River in the Sunan Yugu Autonomous County of Zhangye City, Gansu province, China. The project was approved for funding by the Asian Development Bank (ADB) in 2003 and construction of the dam started in that same year. The International Bank for Reconstruction and Development (IBRD) of the World Bank later submitted a request to register the same project for approval under the CDM allowing the Dutch government to source the anticipated Certified Emission Rights (CER). International Rivers (USA) criticised the project as being clearly non-additional since the project would have happened without finance from the ADB. Nevertheless the UN Executive Board of the CDM registered the project in August 2006.

The various shortcomings of CDM and other emissions trading initiatives, have led some NGOs to the conclusion that market based initiatives for achieving emission reductions of greenhouse gases are not going to work at all. The Durban Declaration on Carbon Trading – currently signed by more than 150 organisations from around the world exemplifies this position. It argues that an effective approach to combat climate change requires shifting focus from diminishing end-of-pipeline emissions towards addressing the root cause of the problem and diminishing the extraction and use of fossil fuels.

While capital flows to developing countries derived from emission trading are barely sufficient to address the needs of poverty reduction and sustainable development, it should also be noted that they do not address the impacts of climate change that are already happening in these countries. The IPCC reports vividly describe how poor people in developing countries are the hardest hit by the consequences of climate change. While accurate figures are not available, estimates suggest that annually around US$ 50 billion might be required to support poor people in developing countries to effectively adapt to the impacts of climate change.

At this moment there is hardly any money available for this purpose. The Global Environment Facility (GEF) is hosting three specific budget lines to fund adaptation related activities, which total just US$ 215 million. The Kyoto Protocol also agreed that 2% of the value of CERs purchased by Annex-I countries will be deposited in a special adaptation fund. Based on the current CDM project portfolio, this adaptation fund might receive something like € 730 million by 2012, far short of what is needed.

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2.3

CAPITAL FLOWS AND TAXATION

Governments and governmental institutions play vital roles in ensuring sustainable development. They are the main source for public finance and are also central in developing and enforcing effective legislation and regulations to promote sustainable development. Taxation can serve two important functions: it is an essential source of revenue to generate the public finance needed to promote sustainable development and can be instrumental in promoting change by placing higher levies on those products and transactions that are less desirable in terms of sustainability.

In practice these two functions of taxation policies are often difficult to separate. Very high taxes on undesirable products and transactions might indeed result in them being phased out, but that can also result in a serious loss of tax revenues. For such reasons, policy makers generally try to balance these different objectives of taxation policy. In addition, political realism also requires that linkages between the origins of tax revenues and the policy measures to be financed with these revenues are as transparent as possible.

Taxation policies play an important role in domestic economic affairs. Many countries have concluded mutual tax treaties, which aim to avoid double taxation or provide for mutual support in tax collection. The OECD, IMF and World Bank have set up the International Tax Dialogue (ITD) that later was joined by the United Nations and several other international agencies.

Unfortunately, the macro-economic prescriptions of the World Bank and the IMF often leave little political space for developing countries to freely decide their tax policies. In many rich countries tax revenues may form at least about 30-40% of their GDP, but they hardly ever reach such levels in developing countries. Given that international aid is not always that effective in reducing poverty, there is an argument that strengthening local taxation systems in developing countries is essential in improving the scope for developing countries to finance their own sustainable development.

In contrast to industrialised countries where domestic tax revenues are the major source of government income, in most developing countries import taxes are a vital source of government income. In the Least Developed Countries in Africa import duties represented about 34% of total government revenue over the period 1999-2001. (In industrial countries the share of import duties normally does not exceed 2% of tax revenue). Given this difference the abolition of import taxes does not pose much of a challenge to industrialised countries, but can cause huge problems for the revenue base of poor countries. Yet, ongoing trade liberalisation talks within the WTO, as well as negotiations for bilateral or regional free-trade agreements, frequently aim to abolish such taxes in order to promote international trade. The resultant loss of revenue seriously undermines the attempts of most developing countries to meet the Millennium Development Goals (MDGs) and to adequately address their long-term needs for sustainable development.

Many developing countries, especially resource rich countries, offer specific tax privileges to foreign investors and justify these on the grounds that, in the absence of local technology and capacity to exploit such resources, foreign investments are very much needed. The export of these resources is encouraged both to boost government revenues and to promote economic growth and sustainable development.

However, these foreign investors and the goods they export are frequently subject to low levels of taxation, significantly limiting the effectiveness of these policies. Foreign investors have relative freedom to move the revenues of their operations elsewhere. This is also true of local companies and economic elites from developing countries which also face few barriers to transferring assets to tax havens abroad, rather than reinvesting them at home.

American researcher Raymond Baker reported in the Financial Times in 2004 that up to US$ 500 billion of capital flight funds flow out of developing countries each year. He argues that this figure has three components: US$ 50 billion of funds flowing from corrupt practices; up to US$ 200 billion from exploiting weaknesses in the taxation system in the developing world (e.g. extraction of profits through transfer pricing abuses), and; US$ 250 billion of ‘capital flight’ money from criminal activity. Together these sums dwarf the annual global ODA budgets. Although the awareness about this kind of problems is growing, well-focused efforts at the multilateral level to address these are not yet forthcoming.
VISIONS ON THE GREENING OF FINANCING MECHANISMS

When thinking about sustainable development one can adopt two approaches to capital flows. On the one hand one can adopt the precautionary approach and focus on safeguarding against the negative impacts of investment plans. On the other hand one may view capital flows as an essential ingredient in advancing and promoting sustainable development. Many environmental Civil Society Organisations (CSOs) are working on the greening of financing mechanisms from this perspective seeking to balance the environmental, social and economic interests of current generations against those of generations to come. As part of this process they involve local communities and their representatives in sharing their intimate knowledge of local environmental conditions. This local knowledge is an essential input in assessing the sustainability of development activities. Many environmental CSOs put diversity at the centre of their vision of sustainability and focus on safeguarding against the negative impacts of investment plans. Both ENDS is convinced that the visions of such CSOs should be given more credence when dealing with capital flows, from both of the angles discussed in this Briefing Paper.

The role of governments and public authorities is normally seen as central in promoting sustainable development. Within the context of the rule of law, they have the mandate and the power to legislate, regulate and make the necessary finance available for meeting these goals. Yet governments cannot do this alone. Civil society, the private sector, consumers and trade unions all have a role to play and a contribution to make. The concept of partnerships, of joint efforts in a spirit of sharing and cooperation, is a recurring feature in terms of vision. In practice however partnerships often prove more difficult, whether we are talking of public-private partnerships, in which CSOs and private corporations work together or of the many instances where Northern and Southern CSOs are working together.

The visions of environmental CSOs usually differ distinctly from the neoliberal economic thinking which holds that market-based approaches, centred around competition are the most effective ways of achieving ‘progress’. CSOs recognise and acknowledge the realities of markets and competition but argue that these economic realities should be subordinated to safeguards that prevent negative social and environmental impacts. Some private companies that consider sustainable development as part of their business responsibility may share such views. Thus many of the CSOs that Both ENDS works with insist that strict environmental and social safeguard policies need to be implemented by all financial institutions, both private and public. Some of the essential elements of such safeguard policies are:

- Information disclosure and transparency;
- Recognition of the rights of all stakeholders for consultation and participation in decision making processes;
- Environmental safeguards with a focus on the protection of the natural environment and the prevention of pollution, including the responsibility to avoid or mitigate

38 This will include income tax, corporation tax, property tax, inheritance tax and value added tax (VAT) on goods and services, etc. In addition international transactions and capital flows are subject to taxation policies, including trade tariffs such as import and export taxes.

39 http://www.itdweb.org/

40 The international Tax Justice Network (TJN) is strongly advocating this line of thinking, http://www.taxjustice.net/


42 The EU is currently negotiating Economic Partnership Agreements (EPAs) with 77 countries from Africa, the Caribbean and the Pacific region. The EU is requiring these ACP countries to accept a gradual elimination of import taxes on at least 80% of their trade with the EU.


44 http://www.intrac.org/pages/researchngo_partnerships.html


46 The Global Reporting Initiative (GRI) has developed guidelines and standards for companies and organisations to use as the basis for disclosure about their sustainability performance and is intended to be complementary to requirements for financial reporting, http://www.globalreporting.org
against negative environmental impacts;
• Recognition and integration of human and social rights, including the rights of indigenous people, land rights or resettlement issues;
• No tolerance of bribery and corruption;[47]
• Monitoring, compliance, and accountability.[48]

Besides this precautionary side, many of our partner CSOs also advocate the need to redirect capital flows so that these truly do foster sustainable development efforts. There are many aspects to this question. Many CSOs see sustainability as characterised by a high degree of self-reliance and prefer to finance sustainable development efforts from local sources. Several of our partner CSOs refuse foreign financial support for this reason. Instead they consider it more sustainable to generate the required capital locally through, for example, local (micro-) saving schemes which they see as a key aspect of sustainable development.

CSOs usually stress that sustainable development is about fostering diversity and some extend this principle to financial diversity. They prefer to fund sustainable development activities through combining external funds with internally generated ones. To avoid unilateral dependency external financial support should come not from one source, but a variety of different sources, both private and public. In line with this, a diversity of funding agencies is preferred above single funding through large financial institutions.

Another related element is the scale of activities. Efforts for sustainable development should allow for mistakes that do not result in irreparable damage. They need to be rooted in local people’s experiences and knowledge, managed from the bottom-up and combine traditional knowledge with modern techniques[49]. Such efforts provide alternatives to more damaging practices and can be easily replicated and adapted by like-minded people elsewhere working in different circumstances and under different conditions.[50] Such efforts for sustainable development do not immediately need vast amounts of money, but can take off with the support of micro-financing and small grants.[51] This is not to say that sustainable development efforts should always stay at the level of small and beautiful. The huge challenges in e.g., climate change (mitigation and adaptation) or the threat of land use change and land degradation for food sovereignty and sustainable livelihoods, clearly require a massive up-scaling of existing efforts and the finance to facilitate this. In the vision of many CSOs this however should be a bottom-up process.

Many CSOs recognise that larger financial institutions like the Multilateral Development Banks (MDBs), Export Credit Agencies (ECAs) and private banks potentially play a very important role in ensuring that the massive investments needed to support sustainable development actually materialise. This requires a major shift in the funding priorities of such agencies and, recognising this, some CSOs have established networks to advocate policy changes to promote social and economic justice and ecological sustainability.[52] A good example of the kind of policy shifts that CSOs are advocating to these institutions is that they consider phasing out funding for the extraction and use of fossil fuels.[53] Currently most of the finance that is available for promoting sustainable development comes from ODA budgets. While it is good that such funds are aligned with sustainable development priorities, many CSOs are convinced that newly emerging priorities will require additional financing from other budgets and argue the need for new, additional and innovative financing mechanisms to be introduced.
INNOVATIVE FINANCING MECHANISMS

Few CSOs have given much serious consideration as to what shape or form new additional and innovative financing mechanisms might take. Given the highly technical aspects of most existing financing mechanisms this is hardly surprising. Instead of thinking in terms of grand schemes CSOs are better placed to develop bottom up and innovative financing schemes from their own realities rather than propose global blueprints. This approach is also more in line with the diversity principle of sustainable development.

Innovative financing mechanisms for infrastructure development require the planning process to be organised in an innovative, participatory manner. An inventory of local demands and needs will make it clear whether existing infrastructure should be upgraded, and the extent to which investments in new constructions are desirable. New infrastructure has to primarily respond to local demands and needs. Sustainable infrastructural development needs to take account of, and fully utilise, available local knowledge and insights.

As a second step external demands and needs should be identified. To ensure high levels of local ownership and participation in new infrastructural plans, it is essential that representatives of the various stakeholder groups take part in the planning process from the very early stage of needs assessment. Whenever conflicts of interest emerge between different groups of stakeholders - both locally and externally - negotiation processes should be embarked upon to ensure that popular support for the new plans does not drop. Such processes should give serious consideration to the concepts and approaches developed at a local level as options or alternatives to the large-scale approaches designed by central planners and their technical staff.

As conventional infrastructure planning largely aims to serve foreign economic demands, its financing, generally through loans or foreign investments is based solely on expected economic benefits. These loans usually leave heavy debts for local stakeholders, denying them opportunities to recover the economic, social and ecological costs imposed by the project. Equally foreign investments allow for little local control or ownership. Innovative financing mechanisms for infrastructure require fundamentally different approaches. For this reason the initial local needs assessment for infrastructure development needs to identify the potential of locally generated financial resources to sustain long-term...
investments. Foreign support should promote the scaling up of successful local initiatives and their replication elsewhere.

A strategic economic and environmental analysis (SEEA) would first of all concentrate on the local economic potential, both in terms of demand and supply. The impacts of different scenarios should be compared and discussed with all local stakeholders. The significance of foreign demand and supply also has to be included within the SEEA. The potential consequences of active demand side management that aims to limit the use of resources through more efficient production processes should also be included in the different scenarios. The likely implications of such demand side management on the role of foreign capital needs to be taken into account and balanced with the local financing potential.

To stimulate sustainable development through infrastructure development, it is of the utmost importance to develop financing mechanisms that allow for the implementation, and eventual scaling up and replication, of local initiatives. This requires setting up small-scale funding mechanisms along the lines of co-financing schemes operated by charities, or the GEF Small Grants Facility.

### 4.2 INNOVATIVE FINANCING MECHANISMS AND CLIMATE CHANGE

Following the conclusions of the Stern Review and IPCC reports, early and strong action addressing climate change and its impacts is clearly warranted. Action is required in many fields, the reduction of emissions, adaptation to climate change, technology support to facilitate decarbonisation and sustainable development in developing countries, reduction of deforestation, etc. Stern recommends that at least 1% of global GDP be used to address these pressing issues. He convincingly argues that this will be substantially cheaper than taking no action. This however requires huge new commitments as it implies an annual budget of close to US$ 500 billion for addressing climate change related issues. It is unlikely that one single innovative financing mechanism will be able to generate such financial resources. A mix of measures, backed up by the development of new financing mechanisms, seems the most realistic option.

An important element will be strengthening the Polluter Pays Principle in climate change related policies. Rather than issuing emission rights to emission-intensive industries for free under international emission trading mechanisms, these rights should be auctioned. The revenues could then be used for financing international climate change policies, including meeting the urgent adaptation needs of the poor in developing countries. At the same time the increased cost of greenhouse gas emissions that such auctions will bring about will contribute to investments in renewable energy and make energy efficiency measures become more attractive.

It is widely accepted that global emissions of greenhouse gasses need to be substantially decreased. The allocation of increasingly scarce emission rights is a bone of political contention and subject to international negotiations. Within this setting some forms of emission trading are likely to continue. Experience shows, however, that these trading schemes, including the CDM, do not deliver much in terms of sustainability or the decarbonisation of the development paths of non-industrialised and industrialising countries. Changes are therefore needed to better focus these instruments towards these targets. These could include limiting trading schemes to specific sectors or geographical regions. In addition much stricter guidelines should be introduced over the kind of projects allowed and technologies used. In a more stringent and more effective carbon market, the prices of emission reduction rights will increase, although in the longer term under such a scenario it should also be anticipated that the volume of emission trading will eventually diminish.

In light of the major investments required for stabilising climate change and its impacts, emission-trading schemes need to be supplemented by other initiatives. Given the difficulties experienced in achieving sufficient emission reductions, some argue that efforts to make Carbon Capture and Storage (CCS) commercially more feasible should be intensified. One of the options suggested is that CCS investments would also secure emission reduction rights. However, from the perspective of climatic integrity, such proposals are far from desirable. Many argue that the overriding focus on emissions in climate change policies results in most efforts being addressed on end-of-the-pipeline proposals. Rather than focusing on reductions of
emissions, it is argued that more emphasis should be placed on reducing the input of raw materials that produce greenhouse gas emissions, particularly fossil fuels\(^57\).

One conceivable way of reducing the production of fossil fuels would be to introduce a global quota system, which would define the maximum quantities of fossil fuels to be exploited. Once such a system was established, these amounts would be reduced annually. A complementary proposal is the introduction of a greenhouse gas tax which would place a levy on every ton of CO\(_2\)-equivalent emitted into the atmosphere. Another option is the imposition of a climate tax on the use of fossil fuels.

While the introduction of new carbon taxation mechanisms has been opposed for a long time, the number of advocates is now increasing\(^58\). The UNDP\(^59\) recently argued in favour of a carbon tax as one of the instruments to be included in future policy mixes. The French President Sarkozy has also declared himself in favour of a carbon tax, the revenues of which could be used to address fundamental needs in developing countries, such as adaptation to climate change and/or the transfer of new technologies that would allow poor countries to simultaneously embark on sustainable development and decarbonisation.

Another potential financing mechanism for climate change related activities is the proposal for a ‘global loan mechanism’ presented by EU Development Commissioner Louis Michel\(^60\). His idea is to embark on a concerted effort to raise the vast amounts of money required to meet the needs of developing countries in responding and adapting to climate change. The world’s richest countries would be responsible for paying back the cash borrowed by developing countries through a new innovative long-term mechanism. The fund could be man-

\(^55\)Free issuing of emission rights was done in the 1st stage if the Emission Trading Scheme (ETS) of the EU: http://ec.europa.eu/environment/climat/emission.htm

\(^56\)Position of the Dutch Minister of the Environment advocated within the EU, Het Financieele Dagblad, 29 June 2007.


\(^59\)Human Development Report 2007-2008 – Fighting climate change: human solidarity in a divided world, UNDP.

**4.3**

**INNOVATIVE FINANCING MECHANISMS AND TAXATION**

Import taxes are an essential form of revenue for the governments of developing countries. This kind of revenue is, as we have seen, under pressure due to free trade negotiations, as well as foreign multinational corporations requesting tax privileges as part of investment agreements. International discussions at the multilateral level are required to prevent the governments of developing countries being drawn into a race to the bottom that forces them to give up substantial parts of their revenues.

There is strong need to strengthen the national political space within developing countries so they are able to formulate and implement their own national taxation policies and generate their own revenue streams. The Finance for Development process of the UN might be the appropriate arena to raise the priority level of such discussions on the international scale. This forum could provide a place for consensus to be reached over those types of import taxes that should be allowed to remain in place and those which could increase. Such consensus then could be bought to the WTO as an internationally endorsed proposal, and this might help overcome the WTO’s ingrained hostility to any discussions about increasing tax on trade.

Another form of trade tax that currently is excluded from the ongoing negotiations at the WTO is an export tax. Export taxes could certainly function as a source of government revenue for developing countries. If applied to products that should not be overexploited, such taxes would also be helpful in limiting external demand, especially at times of low world market prices. The use of export taxation as an effective instrument to promote sustainable development and balancing these two goals generally requires ample fine-tuning.

New financial resources for sustainable development, that could complement traditional ODA-resources, might also be developed through different forms of international taxation. One such example was the proposal by the previous French President – Mr. Chirac – to introduce an aviation tax, the revenues of which would fund development activities. This proposal received mixed responses at the international level, though France itself currently implements a small aviation tax on passenger tickets and freight passing through French airports.

Various forms of tax on international currency transactions have also been discussed – often popularly named the Tobin-tax, after the economist James Tobin who first floated the idea of such a tax in 1972. This tax has been usually proposed as a levy of about 0.1 – 0.25% of the value of any international currency transaction. A key purpose of such a tax would be to discourage very frequent currency transactions, thus enhancing international financial stability. The need for such policy instruments was much more widely felt after the Asian currency crisis of 1997 which was caused by aggressive currency speculation. While regular currency transactions would become little more expensive, calculations suggested that in light of the huge currency flows around the globe everyday, the annual revenues of a Tobin-tax might range between US$ 150 – 300 billion. Though the political will in favour of this tax is still fairly limited, interest in a Tobin-tax has never completely died, especially in view of the size of the estimated revenue that it would raise.

There has also been some speculation of the feasibility of introducing some form of Internet-tax, or more specifically a tax linked to the volume of digital data sent. Aside from the revenues that this would bring in, such a tax might also help in fighting spam. A more specific variety of an Internet-tax would be to tax Internet-based gambling activities. The feasibility of Internet-taxes is likely to depend quite strongly on the political cooperation of the USA, which still has a large amount of technical control over the technology. At present both the WTO and the Internet Tax Freedom Act of the USA prohibit Internet related taxes.
CONCLUSIONS AND RECOMMENDATIONS

This paper has explored how international capital flows influence efforts for sustainable development, particularly in the context of international cooperation between North and South. It notes that private capital flows towards developing countries exceed official capital flows. It also notes that capital outflows from these countries, in particular from emerging markets, are larger than the inflows. Only a very small fraction of international capital flows is deliberately targeted at promoting sustainable development. Preventing negative environmental and social impacts arising from the bulk of ever-increasing international capital flows is a huge and growing challenge.

From the perspective of sustainable development many existing financing mechanisms have serious limitations or create unforeseen problems. This paper deals with challenges in three sectors.

Infrastructure:
A massive amount of public and private money is being invested in large-scale infrastructure development often in remote areas in developing countries. These investments are mainly driven by the demand in industrialised countries for raw materials and natural resources. Such proposals need to be subject to detailed public review. CSOs play a key role in advocating that infrastructural development must first of all serve local needs and aspirations. For reasons of sustainability, foreign capital for infrastructural development needs to be balanced with local financing. Foreign support should support the scaling up of successful local initiatives and their replication elsewhere.

Climate change:
In the field of climate change, the Clean Development Mechanism (CDM) under the Kyoto Protocol has triggered a huge new market for investments in projects in developing countries that will reduce the emissions of greenhouse gases. From the perspectives of environmental integrity and sustainable development, this mechanism is less than perfect. Serious progress in reducing emissions and adapting to the impacts of climate change will require enormous amounts of additional capital, particularly in developing countries. New financing mechanisms and carbon taxation systems are urgently required.

Taxation:
By putting higher levies on specific harmful products and transactions, taxation policies can help to promote sustainable development while at the same time generating the revenues to pay for it. Trade taxes are a much more important source of revenue for developing countries than they are for industrialised countries. However ongoing international trade liberalisation puts tremendous pressures on most developing countries to lower or abolish trade related taxes. These issues need reviewing in the context of the debate of justice in trade. Various innovative forms of international taxation also deserve further examination.

It is easy to underestimate the significance of international capital flows on the scope of sustainable development. While the prevention of the negative impacts of such capital flows is on the agenda of many CSOs, their thinking...
on innovative financing mechanisms is still yet to be developed. Sustainable development is about fostering diversity. Similarly its financing also needs to derive from a wide variety of resources and mechanisms.

One tentative conclusion that we might draw from this Briefing Paper is that one of the reasons that excellent ideas for sustainable development fail to materialise may be because of the lack of feasible financing proposals. Due to technical complexities many find financial issues hard to deal with, and tend to leave this to specialists. Financial experts, however, tend to be focussed on maximising returns on investments, which is quite the opposite from sustainability. Advocates for sustainable development therefore should take up the challenge to put much more energy into the elaboration of concrete financing mechanisms for sustainable development efforts.

*Both ENDS will continue to commit itself to this challenge!*
Both ENDS strives for a socially just and sustainable world. To this end we support organisations in developing countries that are active in the areas of poverty alleviation and environmental management. These local organisations have in depth knowledge of what the problems are and often come up with inspiring, sustainable solutions. We support them by providing information and mediation in funding, lobbying and networking.