Green growth and environmental governance in Eastern Europe, Caucasus and Central Asia

Executive summary

EAP Task Force

GREEN GROWTH AND ENVIRONMENTAL GOVERNANCE IN EASTERN EUROPE, CAUCASUS AND CENTRAL ASIA

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BETTER POLICIES FOR BETTER LIVES

EXECUTIVE SUMMARY

What is this report about?

This report examines the framework for a green transformation of economies in the countries of Eastern Europe, Caucasus and Central Asia (EECCA). To this end, economic and social conditions, market signals and environmental policies are discussed. The report is divided into eight chapters and is largely based on the OECD's analytical toolbox, including green growth indicators. Country profiles are available in an Annex.

Why is greening growth so important?

Worldwide, risks to development are rising as the current models of growth continue to erode the stocks of natural assets and undermine services provided by ecosystems. A lack of action to preserve natural capital will result in increasing costs to substitute it. Moreover, policy needs to take account of evidence that changes in ecosystems, and their capacity to support growth, do not necessarily follow a smooth, foreseeable trajectory. New ways of production and consumption, as well as new approaches for defining growth and measuring human progress, are required in order to avoid the degradation of current living standards.

Green growth strategies aim to foster economic growth and social development while ensuring that natural assets continue to provide the material inputs and services on which our economies and well-being rely. The green transformation can bring many positive development outcomes, such as enhanced productivity and innovation, creation of new jobs and markets, and fiscal revenue generation. Furthermore, by achieving climate change resilience, water and energy security, and adequate functioning of ecosystems, the likelihood of abrupt changes that may trigger economic and social shocks is reduced. To enable greener growth, market signals and policies must catalyse investment and innovation into new ways of sustainably managing natural capital and extracting higher, long-term benefits from its use.

Within the current model of growth, many EECCA countries have intensively and often unsustainably tapped into their natural capital. If Gross Domestic Product (GDP) was adjusted for natural capital depletion, net GDP would be substantially lower. The continuing degradation of the environmental quality of life, high carbon emissions and pervasive energy inefficiency, obsolete and wasteful production technologies, increasing water scarcity and important water losses, particularly in agriculture, as well as costs associated with all these concerns, point to the need of acting more firmly on mainstreaming environmental goals into framework and sectoral policies. In addition, addressing problems related to climate change vulnerability, as well as water, food and energy security becomes critical in the EECCA region.

Where do EECCA countries stand on their path to green growth?

The need for further socio-economic improvements in EECCA countries provides a strong argument for implementing green growth policies. After twenty years of transition, most of EECCA countries have opened their economies, with a sometimes high degree of merchandise, and capital and labour movement. The competitiveness of these economies, however, still needs improvement and orientation towards future, rather than past, growth models. The green growth agenda in this region can be closely aligned with some of the most central development goals, such as economic diversification, increasing the efficiency of production thus competitiveness in global markets, fully harnessing the export potential, avoiding job loss and contributing to fiscal revenue.

Transition has led to structural changes, primarily a higher than average deindustrialization, which has diminished many but not all negative environmental impacts. Nevertheless, the structure of EECCA economies remains skewed towards low value added branches, such as agriculture or extractive industries, which are vulnerable to external shocks and demand fluctuation, hence the need to find new ways of income generation beyond commodities export.

Extremely low energy efficiency imposes substantial costs on EECCA economies each year. For instance, steelmaking in Ukraine requires four times more energy than in China. Energy savings potential across all sectors through improved efficiency and conservation in Central Asia constitutes 35-40% of current consumption. The efficiency of industrial boilers in the Russian Federation is 30% below the best international practice. Energy efficiency measures in the Russian Federation would result in savings that exceed 2% of global consumption and would reduce greenhouse gas emissions by an amount equivalent to the annual emissions of the United Kingdom. Furthermore, if energy efficiency in the Russian Federation approaches OECD values, development in this country can take place without any increase in energy supply over the next decades.

Unless action on energy efficiency in the EECCA region is much bolder than at present, the energy supply potential and the current infrastructure will not able to satisfy rising demands, including in oil and gas rich countries. While half of countries in the region are net energy exporters, several EECCA countries are highly dependent on energy imports, with Moldova importing 97% of its energy needs. In these countries, the energy-related green growth agenda is intimately linked to energy security issues.

In Central Asia, the energy and water nexus is very strong, sometimes leading to economic disruptions. Remote and rural areas, particularly exposed to poverty, have a low and often decreasing access to water services and sometimes energy.

Market signals for green growth have become more pronounced but yet insufficient to drive behavior change, particularly against the background of imperfect institutional frameworks in the EECCA countries. Despite comparatively low (but steadily rising) tariffs for energy, water and other environmental services, an increasing part of household budgets is dedicated to utility payment. At the same time, the financial sustainability of utility companies remains low and requires subsidization. Subsidies are estimated to be particularly important in the region, absorbing sometimes over 30% of GDP. They are a major factor in the poor performance regarding energy efficiency and renewable energy production.

These and several other economic and social factors, such as, for instance, shadow economic activity, relatively low labour productivity, brain-drain, that prevent a more robust, sustainable and inclusive growth, and which make EECCA countries more vulnerable to trends in the global economy. Re-thinking the current development model would bring the benefit of economic competitiveness and resilience in a longer-term perspective.

Examples exist of EECCA countries that already have put in place selected elements of green economy. For example, alternative energy production is increasing in Georgia, Tajikistan and the Kyrgyz Republic. Organic farming brings an increased proportion of agriculture-related income in Armenia, Moldova and Ukraine. The Russian Federation and Kazakhstan have set energy efficiency targets. Energy efficiency is also improving in Belarus. Azerbaijan uses it sovereign wealth fund to finance green projects.

In terms of environmental policies, EECCA countries have made noticeable progress, though the global economic and financial crisis has put some of these gains at risk. A vast toolbox of policy instruments, including market-based instruments, is available. A modern-style policy planning is now well rooted in the majority of countries. Environmental policies gained important ground in development and sectoral policies. Following the introduction of government-wide Medium Term Expenditure Frameworks in some EECCA countries, the links between policy and budget planning have been strengthened. The sophistication of systems in support to problem analysis and decision making is rising, particularly in Belarus and the Russian Federation where monitoring systems have been modernised. The regulatory coverage is widening due to new initiatives in such areas as resource efficiency or consumer policies. Environmental matters are better incorporated in the private sector strategies.

Progress towards greener growth in EECCA is, unfortunately, congested by a suite of market and policy failures and imperfections. These include, for instance, the limited financial viability of green growth projects because of very high lending interest rates, high rates of commodities export, a large informal economy, relatively low prices for natural resources, inadequate or sometimes absent pollution pricing, failure to capture more and better investments because of poorly designed governance frameworks, etc. Imperfections in both framework and environmental policies underpin these constrains.

Framework conditions are still unsupportive to investment and innovation in general and to green investment and innovation in particular. Nevertheless, several countries have put a lot of effort into modernizing such policies. In their turn, environmental policies in EECCA suffer from the presence of obsolete elements alongside modern ones, poor consideration of natural assets' value, unreformed market-based instruments, insufficient implementation, underfunding, etc. Instability in the governance structure and low administrative capacity remain important problems. International agenda and drivers continue to play a prominent role in EECCA, with external support being critical for environmental policy reforms even in richer countries, such as Kazakhstan and the Russian Federation.

There are no powerful agents for the "green" transformation. Even where top political leaders, such as presidents, clearly indicate the need to green countries' economies, the government's capacity to transpose this vision into action and manage reforms is limited. Popular support for environmental policy reform is weak as well but the environmental activism is strong at the local level in some countries.

How progress on green growth could be accelerated in EECCA?

The role of governments will remain crucial to accelerate progress on green growth. While the green growth agenda in EECCA is not yet as prominent as in most OECD countries, green growth goals are already integrated, though to a varying extent, into national development objectives and respective strategies of EECCA countries. Therefore governments in EECCA should avoid engaging in yet another wave of strategic papers development.

Green growth promotion needs a reinforced focus on implementation. This could be done by focusing on the reform of specific policy instruments and their mixes, and conducting more in-depth sectoral work. In order to increase policy coherence between different sectors, mechanisms that help identify inconsistencies, and to address the problem of institutional and budget fragmentation, need to be put in place or strengthened. Overcoming the relatively weak capacity of environmental ministries in the region and their extreme institutional instability will be a major challenge in pursuing green growth in the region. At the same time, the success of green growth promotion will highly depend upon the support and involvement of the non-environmental community, including ministries of economy and finance, line ministries, NGOs and the private sector. Improving the overall governance framework, including public administration, is therefore a pre-requisite for any green growth strategy.

In order to accelerate the process of greening growth in EECCA, both framework and environmental policies need to be addressed within a clear strategy, accompanied by adequate measurement tools. While the sectoral level will be the one where most of the changes will happen, addressing the cross-cutting policies should also be pursued; if not, sectoral reforms will be hindered by unsupportive overall conditions, as it was the case in the past. The proposed cross-cutting policy actions in support of green growth in EECCA are summarised below:

STRENGTHEN PRICE AND TAX INCENTIVES: As part of their shift to green growth, EECCA countries should price natural assets and environmental "bads" more adequately, and reduce public spending on environmentally harmful subsidies, simultaneously taking account of and addressing eventual negative impacts of these changes on poor and vulnerable groups.

In the absence of information on how environmental externalities affect personal well-being, compounded with weak liability regimes, price signals need to be corrected through, primarily, market-based instruments. Though in place since the early 1990s, such instruments are still ineffective in EECCA and require a holistic reform. The pricing of both natural resources and pollution must be brought up to a level that is sufficient to promote environmental and resource efficiency, and sustainable use of natural resources more generally. Existing data point to a strong presence of environmentally harmful subsidies (EHS). Six EECCA countries are leading the global ranking of states that highly subsidize fossil fuel consumption. This makes the EECCA region particularly exposed to such phenomena as wasteful resource consumption, budget pressures, and technological stagnation. Besides helping countries to overcome these problems, EHS identification and gradual removal in EECCA may have important global-level benefits. Further analysis in this area is necessary to better understand the extent of exposure to EHS and the social and economic effects of their removal. Simultaneously, consideration should be given to how existing environmentally related taxes and charges could be reformed. This would provide a basis for considering additional market-oriented instruments, in particular the introduction of payments for ecosystem services. The ministries of environment need to closely monitor the evolution of framework conditions in order to identify "windows of opportunity" for introducing such instruments.

OPTIMISE THE NATURAL CAPITAL INVESTMENT AND RENTS USE: Given the huge economic and social significance of natural resources in EECCA, improving the institutional aspects of natural resource management is one the most pressing steps towards greening economic growth in this region.

Natural resource abundance in many EECCA countries has been and will continue to be, at least in short and medium-term perspective, the basis for the creation of national wealth. Shifting towards environmentally oriented growth can enhance the value derived from natural resources. At the same time, revenue from natural capital has to be managed very carefully and transformed into other forms of capital (foremost, human capital and productive capital). The issues of appropriation, distribution and sound use of the natural resource rents need to be addressed. EECCA countries need to continue their efforts to enhance the transparency of revenues from natural resources and spending such revenues. Also in order to avoid the "natural resource curse", institutions need to be further improved, *e.g.* tenure arrangements, monopoly regulation, or the regulation of concession contracts. A better enforcement of natural resource rights and curbing illegal activities is crucial.

ADDRESS REGULATORY GAPS AND FAILURES THAT HINDER THE GREEN ECONOMY UPSURGE: EECCA countries should further re-design their non-market policy instruments and their mixes in a way to both improve the existing models of production and consumption, and stimulate the emergence of new business opportunities linked to a green economy.

In addition to improving the design and use of market-based instruments, further strengthening of non-market instruments is needed to unleash the potential for increasing efficiency. Environmental regulations that set performance and technology standards should be adjusted in line with green growth objectives. The small and medium-sized enterprise sector has particular needs, which need to be carefully studied and addressed. In this context, countries may need to look at the potential offered by supply chain pressure and green procurement. Information-based instruments, such as eco-labels, may also be useful. A reinforced use of Environmental Impact Assessment and permitting will foster green growth in EECCA by helping to address the environmental side-effects of policies and individual projects and climate change vulnerability. In addition, financial risks of non-compliance with regulatory requirements need to be increased through the reform of liability regimes and fines.

MODERNISE INFRASTRUCTURE AND REGIONAL DEVELOPMENT IN LINE WITH GREEN GROWTH OBJECTIVES AND OPPORTUNITIES: Greening growth in EECCA requires adequate, environmentally-sound infrastructure.

Shifting to a greener path of development requires special attention to infrastructure. Given the long life of infrastructure, it is crucial that decisions on infrastructure development do not lock societies into the use of pollution- and resource-intensive technology. An adequate infrastructure plays the enabling role for other sectors' development and for reducing regional disparities in the level of development. In the context of climate change, the existing, sometimes oversized and obsolete, infrastructure is ill-suited to cope with, or protect people from, extremes like heat waves and floods. EECCA countries would need, therefore, to invest in its rehabilitation and build new infrastructure, where this is more cost-effective. This process should be accompanied by a careful analysis of technical options for modernising infrastructure, the improvement of regulatory and institutional frameworks, sound financial planning, and facilitation of private sector participation. Continued support from development banks and donors is needed. Since synergies between environmental and infrastructure policies are stronger at the regional and urban levels, a better integrated policymaking at these levels is instrumental for fully exploiting such synergies.

STIMULATE "GREEN" INNOVATION AND SKILLS DEVELOPMENT: Innovation policies, which are burgeoning in EECCA countries, should be further extended and implemented.

Innovation primarily needs an adequate overall framework, including supportive labour, trade, and investment policies. By recently developing innovation strategies, EECCA countries, *e.g.* Belarus, Kazakhstan and the Russian Federation, have launched the process of establishing such conditions. But "green" innovation is also influenced by environmental policy. In this respect, more supportive policies are needed in EECCA to combine tools that impose technology modernisation (such as permitting based on best available techniques) with measures to facilitate knowledge sharing and skills development.

ENSURE ADEQUATE ACCESS TO FINANCE: A crucial factor in EECCA is facilitating access to finance and making returns on environmental investments attractive for the private sector.

More adequate access to finance is a prerequisite for enabling green growth in EECCA. Public funding and official development assistance can play a major role in stimulating private sector investment. Policy barriers that hold back private investments, including foreign direct investment, need to be identified and removed. In addition, countries need to be more proactive in tapping into global climate-related funds. Capacity for project and programme identification and preparation needs to be further developed. An important measure is to increase the transparency and accountability of public revenue and expenditure. Public funds have a critical role to play in leveraging private financial flows and investment, as well as attracting support from donors and International Financing Institutions. Greening the public budgets, sovereign wealth funds, government procurement, as well as banks' and micro-finance schemes' due diligence procedures are powerful instruments that remain largely unexploited in EECCA.

USE BETTER ANALYTICAL TOOLS TO CATALYSE AND MEASURE PROGRESS: EECCA countries should systematically apply the green growth lens to their framework and sectoral goals and policies. In particular, the costs of natural capital's degradation need to be fully taken into account.

In EECCA countries, as worldwide, the lack of solid evidence fully revealing the economic consequences of the natural capital's depletion and environmental degradation is often a barrier in promoting the environmental transformation of production and consumption. Environmental ministries in EECCA, in partnership with ministries of economy, can catalyse a further shift in development planning by adopting new analytical tools that would permit them factoring the costs of natural capital depletion into their decision-making. Besides the analysis of costs and benefits of environmental policies and laws, these can include the valuation of ecosystem services, and introducing green (natural capital) accounting more generally. Higher demand and enhanced analytical capacity for the use of these tools are needed. Strategic Environmental Assessment needs to be used systematically. The design of sectoral policies in EECCA can benefit from the "green growth lens" if the real sector of economy is to become more competitive in the global economy. Green growth indicators will need to be developed and adopted to measure progress.

CONTINUE THE REFORM OF FRAMEWORK POLICIES: Framework conditions should be further improved in EECCA. Without addressing them, green growth will not take root.

Green growth is as much about growth, as about green. The soundness of framework policies constitutes a pre-requisite for any further action within green growth strategies. In EECCA, setting the framework conditions right requires a critical review of investment and taxation policies, and a very serious work to improve the governance conditions, in particular the quality of public administration.

What role for OECD as part of the green transformation in EECCA countries?

Future OECD activities in EECCA can continue to draw on relevant projects carried out within the OECD's core programme of work, including the recent work on green growth. OECD could help EECCA countries to devise policies that would enable a more rapid shift towards greener growth, with a particular focus on market-based incentives. This would be bases on the OECD's long-standing experience in supporting EECCA governments to improve and implement policies benefiting both the environment and economic development. Most importantly, future projects may focus on facilitating the identification and gradual phase-out of environmentally-harmful subsidies (EHS) and further reforming economic instruments and strengthening their implementation. OECD could help EECCA countries to leverage further changes in infrastructure development and corporate strategies and spur green investment by the private sector. In particular, activities may focus on promoting technological modernization and competitiveness gains within the sector of small and medium-sized enterprises. Working with International Financing Institutions and local banks to enable private-sector green investments will also be important.

Finally, OECD could help EECCA countries to make more tangible progress in strengthening institutional frameworks and capacity that would enable transition to green growth. In particular, activities may focus on developing roadmaps for green growth transition, capacity development, and further strengthening the budget planning capacity in line with green growth objectives.

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The OECD has monitored trends in the reform of environmental policies and institutions in Eastern Europe, Caucasus and Central Asia (EECCA) countries since the early 1990s. The current report builds on this series of assessments, but with a new focus on environmental governance in the context of green growth. It looks at conditions and opportunities for a green transformation in the EECCA region. To this end, framework conditions, market signals and environmental policies are discussed. The report is divided into eight chapters, and is largely based on the OECD's analytical toolbox, including green growth indicators. Country profiles are available in an Annex. With this work, the OECD aims to provide a good basis for regional and national-level policy dialogue. The work was financially supported by the Government of Norway and Switzerland. The full version of this document can be downloaded from www.oecd.org/env/eap

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