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**ENVIRONMENTAL GOVERNANCE IN THE CONTEXT OF GREEN GROWTH IN EECCA:  
MAIN POLICY CONCLUSIONS**

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For additional information please contact Ms Angela Bularga at the OECD/EAP Task Force Secretariat (e-mail: [angela.bularga@oecd.org](mailto:angela.bularga@oecd.org), tel: +33 1 45 24 98 63).

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**NOTE FROM THE SECRETARIAT**

The OECD has been monitoring trends in the reform of environmental policies and institutions in Eastern Europe, Caucasus and Central Asia (EECCA) since the beginning of their transition to a market economy in the early 1990s. After the 1993 Ministerial Conference in Lucerne, reports reflecting monitoring findings have supported decisions at every “Environment for Europe” ministerial conference. Given the dynamic but also fragile economic, social and governance context in many EECCA countries, as well as the fluctuating political support for environmental action, such independent assessments were important to facilitate policy and institutional reforms in the region. In particular, they had a role in helping countries and donors to define policy priorities. Their value added stems not only from evidence-based analysis, but also from the complementary process of cross-country comparison and peer learning.

The current paper highlights the main policy conclusions from a report that is being drafted in continuation of this series though with a new focus on environmental governance in the context of green growth. This focus was driven by demand from countries following the recent worldwide interest in, and debates about, adopting a greener model of growth.

The paper may be treated as complementary to the UNECE’s “Draft official substantive document on greening the economy: mainstreaming the environment into economic development” (ECE/CEP/S/2011/L.3, issued of 11 April 2011). It takes a cross-cutting approach (compared to the sectoral approach of the UNECE paper) and discusses the needs of a particular group of countries. Sectoral perspectives will need a careful analysis from a country perspective.

The full version of the report is being finalised. Work on this document was delayed because of a late arrival of funds hence an altered strategy and schedule of the report’s development.

## KEY MESSAGES

***A modern development strategy will not be sustainable in the long term if the economic significance of the natural capital is not taken sufficiently into account.***

In countries of Eastern Europe, Caucasus and Central Asia (EECCA), as worldwide, the lack of solid evidence fully revealing the economic consequences of the natural capital's depletion was often a barrier in promoting the environmental transformation of production and consumption. Due to a wealth of new evidence on the "service provider" role of ecosystems, the economic significance of natural assets beyond their use as raw materials became recognised. The costs of substituting such services are enormous. Or, some countries, e.g. the Aral Sea riparian states, are already constrained in their growth because of malfunctioning ecosystems. Environmental ministries in EECCA, in partnership with ministries of economy, can catalyse a further shift in development planning by factoring the costs of natural capital depletion into their decision-making. Besides the analysis of costs and benefits of environmental policies and laws, this can include the valuation of ecosystem services, and introducing green (natural capital) accounting more generally.

***Greener growth has positive development outcomes such as enhanced productivity and innovation, creation of new markets, fiscal revenue generation and lower risks of economic and social shocks.***

Promoting greener technology can support economic restructuring and diversification, which is a top priority for several EECCA countries. To grasp such opportunities already now, many EECCA countries (including oil-rich ones) have enacted energy efficiency laws and policies to promote the use of renewable energy. Increasing resource efficiency is a core economic objective that needs to be pursued in order to remain competitive in global markets, and the low efficiency levels in EECCA create possibilities for competitiveness gains and higher than average returns on investments. Achieving goals related to green growth (such as, for instance, climate change resilience, water and energy security, and adequate functioning of ecosystems) is a prerequisite for reducing the likelihood of abrupt changes that may trigger economic and social shocks.

***As part of their shift to green growth, EECCA countries need to price more adequately natural resources and environmental "bads", and reduce public spending on environmentally harmful subsidies, taking account of how price changes could negatively impact 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 resource efficiency. Existing data point to a strong presence of environmentally harmful subsidies (EHS) that make 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 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 effects of their removal. As concerns the introduction of additional instruments, it may need careful consideration of the overall framework, particularly when the maturity of markets and trust between market players is crucial, such as in the case 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.

***Due to the huge economic and social significance of natural resources in EECCA, improving their management is one of the most pressing steps towards greening economic growth.***

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, building on past achievements. 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.

***Well-designed and comprehensive policies can 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. Environmental regulation should be transformed into a dynamic system that promotes higher performance without jeopardizing good governance and economic growth. The introduction and application of Strategic Environmental Assessment (SEA), including for public expenditure programmes, and 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. Higher demand and enhanced analytical capacity for the use of these tools are needed. Addressing information gaps on the cost of environmental externalities and using risk analysis and information-based instruments can provide important support for market-based instruments. More generally, environmental policies in EECCA need to be better aligned with the policies of ministries of economy and finance, and other line ministries.

***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 the greening of business 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. An important measure is to increase the transparency and accountability of public revenue and expenditure. Greening the government procurement and banks’ due diligence procedures is another powerful instrument that remains unexploited in EECCA.

***Green growth 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. 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.

***EECCA countries need to promote the development and implementation of innovation policies and preserve a skilled workforce.***

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 Russia, 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.

***EECCA governments will need to build the green growth concept into existing policies and institutions and put more effort into implementation.***

Pursuing green growth goals requires a clear strategy and adequate progress measurement tools. Above all, EECCA countries need to avoid engaging in yet another wave of strategic papers development. This could be done by focusing on the reform of specific instruments, sectoral work, as well as on improving policy implementation. In order to increase policy coherence between different sectors, mechanisms that permit to unveil policy inconsistencies, but also to address the problem of institutional and budget fragmentation need to be put in place or strengthened. Overcoming the weakening capacity of environmental ministries in the region and their extreme institutional instability will be a major challenge in pursuing green growth in the region. Similarly, the development of a supportive business environment will be an important enabling factor for green growth.

## BACKGROUND

1. Two decades after the breakup of the Soviet Union, countries of Eastern Europe, Caucasus, and Central Asia (EECCA) continue to be influenced by the past economic models despite an ever increasing heterogeneity of their development. Within the region, at least one third of countries derive their wealth primarily from natural resource rents. Several other EECCA countries are struggling with an economy overly centred on agriculture or heavy industry, and face the challenge of finding new markets. In their capacity of global economic players, EECCA countries are characterised by a blend of strength and weaknesses, such as important human capital, comprehensive regulation or extensive (but obsolete) infrastructure, on the one hand, and, on the other hand, low income, weak institutions thus high risks of investment, over-sized and omnipresent public administration.

2. The EECCA economies range from very small to large. According to the World Bank, two countries of the region are classified as low-income economies, six countries – as lower middle-income economies and four countries fall in the group of upper middle-income economies. A certain “encapsulation” of growth around capital cities or in natural resource rich regions can be observed in several countries, *e.g.* in Armenia, Kazakhstan, and Russia. The share of informal economy is substantive. As concerns the pace of growth, the situation was mixed over the last decade. The early transition economic decline was such that the region as a whole did not recover to the 1990 level of real output until 2004. Between 2005 and 2007, the EECCA countries generally enjoyed stable economic growth, with most spectacular results being achieved in Azerbaijan, where the economy grew at an average rate of 28.6%, followed by Armenia with an average rate of 13.6%. The majority of EECCA countries were hit badly by the 2008 global economic and financial crisis. Today, the objective is to avoid another “lost decade”. However, some analyses suggest that many EECCA countries will recover to the 2008 level of output only by 2013, losing yet another half a decade of growth. This also means that recent progress on poverty reduction is under threat.

3. One of the major obstacles to growth has been the quality of governance in EECCA, with maturing but continuously weak institutions that leave too much room for discretion and decisions driven by vested interests. The business environment has been improving in some countries, *e.g.* Georgia, though it proved to be unstable in several, particularly in countries with rich natural resources. Against the background of limited accountability and transparency, corruption continues to flourish. Lack of separation of powers, a weak judiciary, and passive civil society are chronic.

4. All these make EECCA countries less dynamic and lock them in the past patterns of growth. In the global market, while having important advantages such as comparatively high human and produced capital at the beginning of transition, EECCA countries are gradually losing them in face of growing Asian and other emerging economies where market reforms have advanced more rapidly.

5. Economic restructuring along the lines of a green economy may become a solution for diminishing the gap between the EECCA region and OECD and emerging economies. But expectations linked to the green growth agenda are still rare and very modest in EECCA. On the contrary, there are often doubts about the feasibility of this development model, which are echoing the older “let’s pollute now, and clean up later” approach. This contrasts not only with the trends in OECD countries, but also with the EECCA’s Asian neighbour China that is rapidly changing its environmental paradigm in order to be a frontrunner as a “new green economy” develops globally. At the same time, the idea of green growth in EECCA is not new: the integration of environmental and economic objectives has been a focus of the “Environment for Europe” process since its creation. Unfortunately, the environmental policy integration movement has been long confined to the environmental community gaining little ground in economic, finance, or sector-specific communities.

## PURPOSE AND ANALYTICAL BASIS FOR THE GREEN GROWTH DIAGNOSIS

6. Proceeding from the understanding of the present growth models in EECCA, the report “Environmental governance in the context of green growth in EECCA” looks at the possibilities for a “green” transformation of these models. To a great extent, the report discusses how environmental policies (and, respectively, environmental authorities) and international initiatives and assistance could play a greater role in facilitating this process. The analysis, performed as part of the report’s preparation, is based on the diagnostic approach developed by the OECD as part of the organisation’s work on the Green Growth Strategy (GGS). The secretariat looked at the existing market and policy signals in EECCA using the toolbox that resulted from the GGS work.

7. While there are several terms and definitions in the field under discussion, in particular those emerged from the UNEP and UNESCAP work, the current paper uses the definition applied in the OECD work. OECD defines “green growth” as a model aiming at maximising economic growth and [social] development while avoiding unsustainable pressure on the quality and quantity of natural assets. In consequence, a “green growth strategy” can be largely seen as a policy framework catalyzing a shift in production and consumption models by strengthening linkages between the economic and environmental dimensions of development, and by highlighting the opportunities for new sources of economic growth and poverty reduction. A distinctive feature of this framework is the promotion of natural capital valuation and the internalisation of costs related to this capital’s depletion. The green growth concept does not replace the sustainable development concept: it is meant to be a more practical mechanism for realising the goals of sustainable development.

8. Though green growth is relevant to all countries, the policies and approaches used to anchor this new model in everyday behaviour will have to be tailored to specific regional and national circumstances and stages of development. The choice of such policies and approaches, and their mixes, may be influenced by a number of factors, for instance the weight put on environmental wellbeing, market conditions (e.g. the share of informal economy or the maturity of financial markets), or specific governance conditions (e.g. weak capacity in policy design or implementation).

9. The incentive framework in support to the green growth objective requires a mix of policy instruments. Notwithstanding differences in national circumstances, putting a price on pollution and the natural resource use should be a central element of any policy mix. The responsiveness of businesses and consumers to price signals can, in many situations, be further strengthened through better regulation and information-based measures (i.e. non-market policy instruments).

10. Given the relative strengths and weaknesses of different policy instruments, their optimal choice will vary by environmental issue as well as across country or region-specific circumstances. Difficulties in monitoring environmental performance, collecting environmental taxes or setting up new markets may influence the choice of policy instruments in countries with large informal economies and where there is weak capacity in environmental policy design or implementation. Distributional effects may play an equally important role in policy development: politically successful measures will have to address equity concerns by correcting for any adverse social impacts. For example, low-income households could be subject to various compensation mechanisms.



11. The green transformation will need policy action, but also windows of opportunity, to overcome dependency upon past “dirty” technologies, obsolete infrastructure, or habits of consumption. Innovation needs to be fostered to help provide ways around old patterns of production. Infrastructure modernisation is a particularly important ingredient for the success of the green model of growth. A change in norms and habits of consumption is also needed.

12. Even though better pricing of resource use and pollution, and smarter regulations, can help provide incentives for such shifts, more than a change in environmental policies will be needed to overcome the inertia. Some other important ingredients for success include improving macroeconomic policy, financial markets, the quality of human capital (thus education and labour market policies), and establishing more effective institutions that would promote efficient investment, fair competition, sound innovation and private entrepreneurship while maintaining social protection and guaranteeing the rule of law. It means that in addition to environmental policies, framework policies need to be improved as part of the green growth transformation.

**GREEN GROWTH STRATEGIES FOR EECCA:  
BASELINE AND AREAS FOR ACTION**

13. Countries need to address two sets of policies that are essential elements to any green growth strategy:

- i) framework policies, including overall fiscal and regulatory settings, and labour and innovation policies; and
- ii) environmental policies that are specifically targeted at incentivizing the efficient use of natural resources and making pollution and environmental degradation more expensive.

None of the two sets are well-functioning in EECCA. The stated goals of both framework and environmental policies, however, tend to be sufficiently aligned with the green growth agenda.

14. While recognising the primary role played by overall policies, the discussion in this paper focuses on the role that environmental policies, and policy analysis tools, may play in facilitating green growth in EECCA. At the same time, having some understanding of synergies between green growth objectives and framework policies is important. In EECCA, green growth would support the objectives of economic diversification, needed to overcome the over-dependence upon natural resources, increasing the efficiency of production (thus competitiveness), fully harnessing the export potential, avoiding job loss and contributing to fiscal consolidation, as well as helping to ensure energy and water security. An objective at the interface of environmental and economic policies is avoiding costs of environmental degradation, which, according to the World Bank, are as high as 9% of GDP in Tajikistan. Finally, addressing climate change vulnerability becomes critical.

15. Are environmental policies in EECCA sufficiently bold to support these development objectives? In terms of their overall design, these policies are, in fact, relatively sound. A vast toolbox of policy instruments, including market-based instruments, is available. Market-based instruments have been used in EECCA since the early 1990s, being first introduced back in Soviet times. New economic instruments are being used or piloted in several countries, e.g. product taxes or payments for ecosystem services. A modern-style policy planning is now well rooted in the majority of countries, with Armenia, Georgia, Tajikistan and Ukraine recently having completed or completing new National Environmental Action Plans (NEAP), and Moldova launching its third cycle of NEAP development. Environmental policies gained important ground in development and sectoral policies, e.g. in Armenia, Azerbaijan, and Kazakhstan. Following the introduction of government-wide Medium Term Expenditure Frameworks, the policy and budget planning are better linked. 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.

16. At the same time, environmental policies in EECCA malfunction due to the presence of obsolete elements alongside modern ones, poor consideration of natural assets' value, weak price signals, 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 donor aid being critical for policy reforms even in richer countries, such as Kazakhstan and the Russian Federation. Internally, there is no powerful agent 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 very limited and stifles change. Popular support for environmental policy reform is weak but the environmental activism at the local level is rising.

17. The proposed policy actions in support of green growth in EECCA, summarised below, proceeded from these features of environmental policy. Nine areas of action are suggested. Certainly, each country will need to adapt the green growth strategy to their context. However, all will have to avoid the focus on form (*i.e.* on producing another strategy paper).

### **Action area 1: Enhance the soundness of decisions on the country's growth model**

18. As already mentioned, the development path of EECCA countries is highly affected by the economic heritage of the Soviet Union, with its planned and isolated economy, largely based on revenue from the commodities export and skewed towards heavy industries that had the military as the major client. Overcoming this heritage required important restructuring of the economy, which has been a major preoccupation of EECCA governments over the transition period. This process is still on-going, with efforts to modernise the economic structure and country's development path being presently renewed and reinforced in, for instance, Kazakhstan and the Russian Federation. The discussion around the green growth agenda can contribute towards better informing and gearing such efforts and make EECCA economies more competitive in both today's and tomorrow's world.

19. A major feature of green growth strategies that can benefit economic and development planning in EECCA is its focus on optimal investment of the natural capital. Defining the true value of this capital (and costs of its depletion) is an important step for enhancing the soundness of economic decisions and for enabling a well-informed choice of future economic models. To this end, the introduction and systematic application of a suit of analytical tools are necessary. Those tools would aim at:

- Assessing the economic significance of natural assets and defining actions that would ensure the sustainability of revenue flows related to the productive use of such assets in the long-term, or transformation of such revenue into other forms of capital;
- Quantifying immediate and future costs of environmental degradation (loss of ecosystem services) resulting from the current models of production and consumption, and defining new or strengthened actions to reduce such costs and internalise them in prices.

20. In principle, no development strategy should be adopted without addressing, at least partly, this kind of gaps in the knowledge base. Presently, such analysis is very sporadic even in OECD countries. In EECCA, the poor understanding of the economic consequences of the natural capital depletion, including the loss of ecosystem services, is widespread, very limited data being available due to the work of international organisations, primarily the World Bank, *e.g.* in Armenia, Moldova and Tajikistan. In the absence of such evidence, or because of poor knowledge of politicians about relevant data, the declarative, opinion-based decision-making is likely to persist in EECCA, especially where there this approach results, among other things, from a low electoral pressure. Past experience shows that economic evidence does have a role in attracting political and popular support to action in EECCA. Thus, valuation studies carried out in Moldova in the mid-1990s propelled the improvement of water sector's performance to the very top of the government's and donors' agenda.

21. Environmental ministries, particularly in partnership with ministries of economy, can catalyse a shift by applying relevant analytical tools. Besides the analysis of environmental costs and benefits of policies and laws, and the Strategic Environmental Assessment of development programmes, the toolbox can include the valuation of ecosystem services and a systematic environmental screening of public spending policies. Economic and social impact studies need to be conducted in conjunction with specific projects as well, as part of regular Environmental Impact Assessments. As pointed out in the OECD's report to the Belgrade Ministerial, a strategic investment in skills, particularly in the environmental economics area, is critical.

22. More generally, indicator sets will need to be adjusted since integrating economic and environmental policies requires a matching measurement framework. In this respect, EECCA countries will need to enhance the existing sets of indicators, particularly with the above-mentioned data describing the natural asset base, including in terms of its value. Besides being analytically sound, green growth indicators will need to be powerful politically and be able to effectively reach individuals in order to enable a behaviour change.

### **Action area 2: Manage natural assets more wisely and avoid a deeper “natural resource curse”**

23. Many EECCA countries are richly endowed with natural resources and derive a substantial part of their wealth from the use of this natural capital, ranging between 11 % in Armenia and 76% in Azerbaijan of total wealth compared to only 2 % on average in OECD countries. In most of these countries, GDP growth and a positive balance of trade have been maintained due to the export of natural resources or derivative (but still low value added) products, which may be as high as 80% of total export, as in Turkmenistan. These characteristics make several EECCA economies remain entrenched in the rentier model of growth, thus very vulnerable to fluctuations in external factors, such as volatile prices on commodity markets. It also exposes them to the “natural resource curse” that can be overcome only if natural resource management is strengthened and the shift towards more value added economic activities is facilitated.

24. The high dependence upon natural resource related sectors, agriculture in principal, is an important feature of the labour market in at least half of the EECCA countries. In Tajikistan and Georgia, these sectors provide more than 50% of jobs. Together with economic restructuring, some of these jobs are likely to disappear, although “greening” agricultural production may save some of the jobs that will be inevitably lost as production becomes more cost-effective.

25. It is clear that natural resource abundance will continue to be the basis for the creation of national wealth in EECCA in the future. While changing the revenue base in a short to medium-term perspective is hardly possible, EECCA countries can derive higher economic benefits from a wiser management of their natural capital. There are opportunities for reducing wastage during the extraction and transportation phase: for instance, the annual value of the region's flared and vented gas is in the range of USD 10-20 billion annually. Curtailing illegal logging can recuperate revenue equivalent to some 20-50% of the timber market. There may be many other examples of such areas for action and countries need to further identify them. Certainly, vested interests and corruption are important impediments to change, at least as concerns the fight with illegal extraction and black markets of natural resources.

26. Emerging environmental policies in consumer countries, primarily in the European Union and the United States, may affect those markets, and the export potential of EECCA more generally. The wider use of timber certification is just one example. In this regard, improved natural resource management is necessary in order to fully maintain the export potential that could be further enlarged based on the promotion of green growth-related branches, such as organic agriculture.

27. Revenue from natural resources needs to be managed in a way to substitute the depleted natural capital by other forms of capital, namely the human and productive capital. This is particularly true for countries largely relying on non-renewable resources, such as Azerbaijan, Kazakhstan, Kyrgyz Republic, Russian federation, Turkmenistan and Uzbekistan, given that these resources can by definition be only depleted. In the case of countries using renewable resources, such as Georgia and Moldova, where there is scope for continued exploitation at economically profitable levels, management decisions need to be particularly careful and natural resource tenure must be accompanied by specific and strict environmental conditions. Developing and putting environmental accounts in place is an important future task for all countries that want to optimise the reinvestment of, and maximise returns on, their natural capital. Ensuring the transparency of revenue from, and expenditure linked to, natural resources is also of utmost importance.

28. At the same time, countries need to understand the limits to natural capital substitution. These limits are defined by the ecosystems' capacity to provide services such as water purification or climate regulation. Some of the EECCA countries, e.g. Moldova, Kyrgyzstan, and Ukraine started to pilot the use of a tailored policy tool – payments for ecosystem services. Its further diffusion in the region will, however, be highly dependent upon the maturity of framework conditions.

### **Action area 3: Adjust price signals, with due consideration of social impacts**

29. Price signals in support to green growth are becoming stronger but are still insufficient for a behaviour shift in EECCA. Consequently, greener growth requires some government action to redress this situation. While in absolute terms, energy and water prices may seem low, they have seen a steep increase over the last decade if compared with the baseline situation, e.g. water prices for households have increased up to 15 times. Respectively, the share of services within the household expenditure structure has augmented from 10-15% in 2000 to 20-30% in 2008-2010 that, in principle, may provide sufficiently strong incentives for changing individual behaviour. It is not clear how the structure of enterprise costs have evolved though the relatively low resource prices in comparison with international benchmarks mean that their competitiveness was not affected because of this factor (other factors, however, may have led to an increase in imports). As concerns pollution pricing, several countries have recently updated their Tax Codes and adjusted for inflation the base rates of pollution charges.

30. All EECCA countries have introduced elements of market-based instruments since the early 1990s when pollution charges were first adopted. Today, these countries possess a relatively rich toolbox of market-based instruments for environmental protection that also includes (though not in all countries) user and product charges, damage compensation, and performance bonds. Some countries have been experimenting with tradable permits and, more recently, with payments for ecosystem services. In addition, the practice of applying administrative payments for permitting, and lately of licence awards through auctioning, exists in a number of countries. Pollution charges remain the main and most comprehensive type of economic instruments used in EECCA. Fines, which strictly speaking are not economic instruments, are applied frequently but with questionable environmental outcomes.

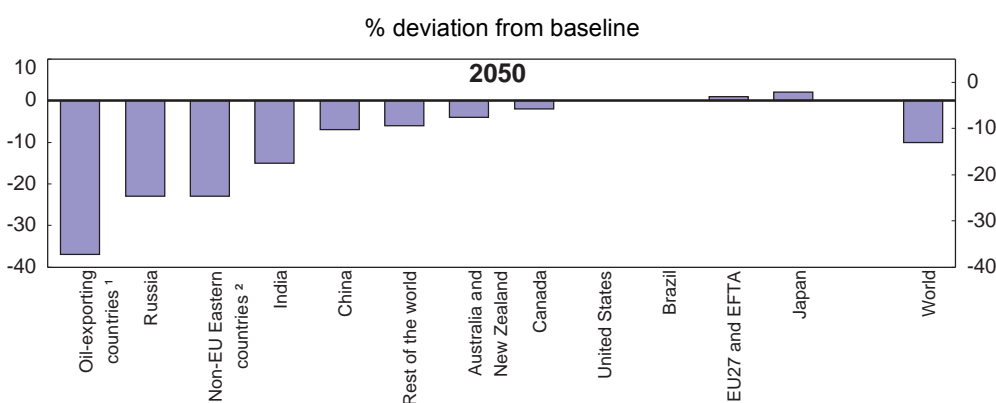
31. Because of their poor design and application (for instance, low basic rates or insufficient collection), the environmental effectiveness of market-based instruments remains insignificant and most of these instruments play a somewhat marginal revenue-raising role. Paradoxically, environmental authorities have attached a lot of attention to the fiscal function of these instruments since in several countries the existence of earmarked environmental funds was possible due to pollution and in some cases product (fuel) taxes. Such funds were often seen as a mechanism to compensate for “symbolic” budget allocation for the environment. Also domestic under-pricing of many natural resources (such as energy, water, timber) and, possibly, tax preferences for producers (for example in mining, forestry and fisheries) contribute to their unsustainable use. On-going reforms of market-based instruments are rather haphazard and narrowly

focused on one-two instruments. Experience shows that despite their multiple (fiscal, poverty reduction and environmental) benefits, such reforms have often encountered difficulties because of unsupportive governance context and immaturity of markets. Indeed, promoting such reforms work in EECCA has been a challenge due to their large informal economy and limited tax collection capacity.

32. Very little analysis exists as concerns countries' exposure to environmentally-harmful subsidies and the consequences of such exposure. Available data show that fuel subsidies may consume up to one third of the GDP, as in Uzbekistan. Thus, besides creating incentives for improved productivity, the removal of such subsidies can improve budgetary position. Their removal can also, according to modelling results (Figure 1), play an important role in the reduction of greenhouse gases (GHG). It has to be mentioned that 5 out of 20 most GHG-intensive economies in the world are EECCA countries, with the following ranks: Uzbekistan – 2; Kazakhstan – 8; Ukraine – 11, Turkmenistan – 12, and Russian – 15.

33. Removing such subsidies can help to free up public funds while also providing stronger incentives for changes in the environmental behaviour. A range of subsidy programmes need to be reviewed in this regard e.g. subsidies to fossil fuels, water use subsidies, and agricultural production subsidies. The decision on priority sectors needs to be made at the country level.

**Figure 1. GHG emissions with fossil fuel subsidy removals**



1. The region includes the Middle East, Algeria-Libya-Egypt, Indonesia and Venezuela.
2. This region includes Armenia, Azerbaijan, Belarus, Croatia, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, Ukraine, Uzbekistan.

Source: OECD ENV-Linkages model based on subsidies data from IEA.

34. At the same time, EECCA countries can use subsidies as a positive incentive in conditions when pricing instruments are too difficult or costly to enforce. Used in a targeted manner they can help shift the balance of incentives towards more environmentally sound products and practices or to support innovative technologies. Subsidies have also been common in the area of energy efficiency to enable low-income groups to gain from the economic benefits of conservation. These programmes typically lower the up-front capital cost of investing in energy efficiency improvements, by offering grants, tax credits, or low-interest loans. However, subsidies do involve complications around targeting and how to find or redirect limited public funds. The demands that they place on governments in terms of administrative capacity and information requirements are considerable. Moreover, to be efficient, resistance to specific pleas from the affected sectors is necessary. As such, they require careful consideration in the context of green growth.

35. Although the adjustment of price signals is a much needed step, it is extremely sensitive from the political and social points of view. The distributional effect of subsidy reform and environmental fiscal reform (losers and gainers from the reform) more generally needs therefore to be examined very carefully. Low income households can be vulnerable to these reforms as the percentage of their expenditure on services is higher compared to rich households.

36. In the process of moving towards a more effective design of economic instruments for environmental protection, EECCA countries will benefit from a continued exchange of experience and knowledge between the countries. They share many similarities in institutional framework and can benefit from mutual experiences. The effects from this effort can be further enhanced through the involvement of representatives not only from the environmental bodies, but also from bodies dealing with economy, finance and taxation.

37. The OECD and Central European countries have experience of the actual use of the instruments in market-based economies. Such experience should continue to be used as a source of inspiration and guidance for EECCA countries in their future efforts, albeit with respect for the different conditions that they have. Maintaining forums that facilitate such experience sharing within EECCA and with OECD and CEE countries, can assist in this process.

#### **Action area 4: Use extended policy mixes in support to sustainable production and consumption**

38. Energy efficiency remains low in the entire region. Compounded with an ageing energy infrastructure, this increases the region's vulnerability to energy crises and exposes to the risk of brutal shock the entire economy. According to the World Bank, it is very likely that an energy crunch could hit several countries in the region in the next five or six years if both demand and supply side are not addressed, with a bill of some 3% of cumulative GDP to be expected over the next 20 years if the region wants to meet its anticipated energy needs. The extraction of mineral resources is often accompanied with significant wastage, *e.g.* with huge mine tailings that also cause human health concerns. There are examples of economically profitable deposits of some minerals being close to exhaustion, which goes against the popular view of endless resource richness of these countries.

39. Indicators show that very modest decoupling has been attained vis-à-vis the total water consumption. Although water resource withdrawal is relatively stable, its consumption continues to be wasteful. In 2005-2008 water losses ranged between 6-7% in Belarus and Moldova and 32-33% in Armenia and Azerbaijan. Since 2005, some countries managed to at least stabilize water losses. Agriculture is a major water user in several countries. Thus, in 2008 water consumption for agricultural needs (mostly irrigation) accounted for 88% of total water consumption in Armenia, 84% in Kyrgyzstan, 69% in Azerbaijan, and 55% in Kazakhstan. In Uzbekistan, the average rate of water use for irrigation has been 90.2% (2002-2006).

40. Simultaneously, household consumption is steadily increasing, often based on imports, particularly in countries where the contribution to GDP of remittances from citizens working abroad is high. While the level of consumption is far behind OECD countries, its environmental impacts are not negligible given the insufficient environmental performance of goods, *e.g.* cars, or the lack of infrastructure for waste recycling and adequate disposal.

41. The combination of inefficient production and rising unsustainable consumption is dangerous to economic development in the region. While most EECCA countries are resource-abundant, they are likely to be confronted with eventual scarcities resulting from this pattern of growth. Thus, addressing resource efficiency is a matter of present economic policies.

42. Policies to adjust prices are, in principle, the best cure for resource inefficiency. However, applying this strategy too aggressively may give rise to strong opposition in EECCA countries where affordability concerns are high, where people conserve the memory of low resources prices and where the liberal model of development is not in vogue with politicians. Therefore, while preparing the ground for price adjustment and gradually putting in place more adequate price signals, EECCA governments may want to use more actively complementary – more “politically” feasible – policy tools, including direct regulation and information-based instruments. Doing this in sectors where opportunities to pick the “low-hanging fruit”, i.e. where increased efficiency can save money, is the best start. Careful identification of sectors and actions with such a potential is necessary, and there is sufficient evidence and good international practice that may inform this process.

43. The imposition of performance standards can prove to be a good substitute for price-based instruments, provided that compliance with these standards can be reliably verified and enforced. In this regard, EECCA countries that are introducing integrated permitting for large industry, e.g. Belarus, Kazakhstan, Russia, and Ukraine, need to further invest into capacity development within their regulatory and enforcement agencies. The application of general binding rules needs to be enhanced particularly where it constitutes a less costly and more affective substitute to performance standards. EECCA countries also need to take advantage of the benefits associated with the private sector’s voluntary initiatives that have widened due to a strong drive from the UN’s Global Compacts or the Global Reporting Initiative. The promotion of ISO 14 000 series certification and support to cleaner production centres may play a continuously positive role in fostering voluntary initiatives. Increased use of rating and eco-labelling will also usefully supplement this mix of instruments, provided that collecting and disclosing such information to consumers is not too costly for the government or firms and that labelling can change the consumer behaviour. Given high rates of public consumption in EECCA, greener public purchasing could be used though analysis is needed to understand if conditions for the use of this policy instrument are supportive in the region.

#### **Action area 5: Create conditions for the emergence of “green” business**

44. Improved environmental policies can also catalyze the creation or widening of new “green” businesses by providing necessary incentives. The current share of such businesses is not clear due to insufficient statistical information. However, there is anecdotal evidence – from media or specialised exhibitions – that such businesses are emerging in the region, particularly in the energy sector. New business opportunities are also emerging in agriculture, particularly in Moldova and Ukraine.

45. New and improved technologies in energy production, such as solar power, biomass, micro-hydro power and biofuels, linked with new approaches to electricity generation and distribution, could reduce the costs and improve the technical feasibility of energy supply in EECCA countries and allow non-oil producing countries, e.g. Moldova that imports 98% of its energy needs, to become more energy self-sufficient. They would also bring a range of benefits, including reduced dependence on fossil fuels, and lower energy bills for firms and households.

46. Besides improving the business climate in general, establishing policy incentives for new businesses may require the application of specific regulatory tools. Several countries already took this path by enacting energy efficiency laws and working on new building standards. A new approach to regulating small and medium-sized enterprises may be needed to unleash this sector’s potential. As mentioned above, extending the use of information-based instruments may help to channel consumer preferences towards “greener” products and services, though they will be in great part affected by affordability considerations.



## Action area 6: Seize opportunities for making infrastructure and territorial development greener

47. The quality of the infrastructure is an important determinant of environmental efficiency and climate change resilience. Once in place, the infrastructure will influence these for a long period that may span 25-30 years or more. In EECCA, the existing Soviet-era infrastructure was designed to satisfy needs that do not fully correspond to the current ones. It is often wasteful, as are heating and water networks, can be oversized (as water infrastructure), or, on the contrary, very limited (as municipal waste management infrastructure). Over the years, it has been deteriorating because of poor maintenance regardless of the sector, be it energy, transport, water, telecommunications. Besides creating risks for human health and the environment, the absence or underdevelopment of infrastructure, as well as the low quality of service, constitute an important impediment to local development being a factor that dissuades investments.

48. In this context, EECCA countries face the challenge of defining the type of infrastructure needed in support to further social and economic development with due consideration of environmental and climate change adaptation and mitigation challenges. No doubt, cost considerations will shape up such decisions. The extent of future demand will, in turn, influence costs. Bold but realistic environmental targets (e.g. for energy and water resource saving, and waste reduction), backed with credible policy measures by the government to ensure their achievement, will help countries to reduce costs at least partly by addressing the demand side.

49. Efficiency gains are to be expected from making utility services more transparent and applying computer-based solutions to optimise the functioning of networks.

50. The uptake of new technologies, particularly in the energy sector, may help to ensure a higher supply to meet demands that are expected to increase. Although dispatching new technologies will take time in EECCA, infrastructure networks may need to be designed with their future use in mind.

51. Strategic use of “ecological infrastructure” (urban forests, grasslands, and wetlands) that exists in certain settlements in EECCA can also reduce costs of infrastructure, for instance the infrastructure for storm water management. In addition, such “ecological infrastructure” provides climate regulation opportunities. Unfortunately, urban development in EECCA has sometimes disregarded these considerations with authorities allowing the reduction or sometimes destruction of urban green areas. To address this and other similar problems, governments in EECCA may want to reinforce both environmental conditions of territorial planning and development, and policy coherence, compliance monitoring and enforcement from a multi-level governance perspective.

52. Better integration of policymaking between different levels is instrumental in fully exploiting synergies between environmental and infrastructure policies that are particularly strong at the regional and urban levels. There are examples of cities and regions in EECCA making first steps on this way, e.g. as concerns the development of water supply and sanitation.

53. The sustainability of transport networks will also need to be addressed since local air pollution is mostly a transport-driven problem in many EECCA cities, e.g. in Yerevan and Almaty. Policy instruments to promote sustainable transport in the short term include a range of measures, such as, for instance, the tightening of vehicle emission standards, better regulation of traffic flows, changing the driving habits through education, congestion fees, etc.

54. In promoting greener infrastructure, EECCA countries may be guided by internationally developed “roadmaps”. One of the most recent examples is the Amsterdam Declaration adopted by the Third High-level Meeting on Transport, Health and Environment in January 2009. Networking between relevant parties may also be helpful for speeding up the diffusion of good practices, and the European Green Cities Network, established in the mid 1990s, has set a useful precedent in this domain.

55. Regardless of the type of infrastructure, adequate financing is a principal challenge for its development. EECCA countries face particular difficulties and financial burdens to modernise their infrastructure. Similarly to OECD countries, though on a different scale, they need to invest both in the rehabilitation of existing networks and build new infrastructure.

56. Policy failures have contributed to the very difficult situation with fund allocation for infrastructure. The improvement of regulation and institutional frameworks, sound financial planning, and facilitating private sector participation are therefore crucial.

57. Many EECCA countries have included infrastructure projects in their anti-crisis/recovery programmes, financed from public funds, including stabilization (sovereign wealth) funds. At the same time, massive upfront public investments are hardly affordable even in oil-rich EECCA countries and continued support from development banks and donors is needed, as well as the use of public funds to leverage private sector investment.

58. Admitting that greening of infrastructure in EECCA will not happen in the short term, it would be important to guarantee however that investments into infrastructure are made with a full understanding of its environmental impacts and climate change adaptation needs. To this end, the environmental ministries in EECCA need to improve the instrument of Environmental Impact Assessment (EIA) so that it acquires green growth and climate change adaptation aspects, and reinforce the EIA application.

#### **Action area 7: Enhance the knowledge base and innovation for greening the growth**

59. Information asymmetries are considerable in the region. While access to environmental information is improving due to the Aarhus Convention and its relatively well-working compliance mechanism, the general public and even the business circles are rarely able to interpret the meaning of disclosed environmental information, including as applied to their personal well-being, specific production processes or business development projects. Further work to make the existing information meaningful and fully playing its function of incentive provider is necessary, while also improving the analytical soundness and scope of data collection and management.

60. Efforts to enhance environmental awareness and education are often happening against the background of eroding knowledge base in EECCA that has resulted from brain drain and a general degradation of the education system. The example of Kyrgyz Republic that despite impressive efforts to devote resources to education, with 20% of public resources reserved for this purpose, has achieved disappointing results may ring the bell for other countries. Establishing a competitive economy, be it green or not, requires a highly educated workforce. Thus, efforts will be needed to improve both education policies and the governance arrangements that enable their implementation in EECCA.

61. Innovation and a skilled workforce are essential ingredients of green growth. By recently developing innovation strategies, EECCA countries, *e.g.* Belarus, Kazakhstan and Russia have launched the process of establishing adequate framework conditions to boost innovation. But “green” innovation is also influenced by environmental policy. In this respect, more supportive policies are needed in EECCA combining tools that impose the need of technology modernisation (such as permitting based on best available techniques) with measures to facilitate knowledge sharing and skills development. Providing assistance to small and medium-sized enterprises is particularly important. Better access to finance is another factor enabling business-led innovation.

62. Investment in research provides the foundation for future innovation; in the absence of immediate commercial application, research is unlikely to be undertaken by the private sector. There is evidence that countries like Kazakhstan and Russia have provided some public funds to research that may foster green growth, through the outcomes of this support are not clear. Budgets dedicated to green research are not regularly monitoring though, as experience shows, innovation for greening growth may result from spill-over effects from other sectors, for instance information and communication technology. In this context, it is worth noting that the value of research and development as share of GDP has increased since 2000 only in Russia (achieving 1.7% of the GDP in 2009), while in other countries it stagnates at very low levels or has seen a decline. Surprisingly, the number of personnel engaged in research and development in EECCA has not decreased over the last decade (except for Moldova, Tajikistan and Ukraine). Given the significant potential for research and innovation to reduce the costs if meeting development goals, governments may want to look at domestic and international opportunities to increase public investment in relevant research.

63. Not least important for innovation are adapted labour policies. Establishing better links between private sector actors and academia is necessary. EECCA governments will also need to invest in research, and overcome the current stagnation at a very low level or decline (except for the Russian Federation) of related public expenditure. Reducing barriers to trade and investment will be important in order to allow for an influx of technologies developed globally. Finally, an adequate protection of intellectual property rights is necessary.

#### **Action area 8: Facilitate the “greening” of public and private spending**

64. Access to finance for environmental investments in EECCA is limited. Domestic capital and financial markets are weak and borrowing is expensive, hence the role of the domestic financial sector in environmental investments is negligible in most of the countries. Public support, including from extra-budgetary environmental funds (where these exist) and donor aid, remain significant sources of finance for environmental investments in some, though not all, EECCA countries.

65. At the same time, public environmental expenditure while increasing in absolute terms is eroding as share of GDP, and does not exceed 0.8% of GDP (2008). As a share of total government budgets, environmental authorities’ budgets in 2005-2008 have ranged between 0.85% (the highest) in Georgia to 0.11% (the lowest) in Uzbekistan. This picture may be more nuanced, however, since environmentally-related spending is spread over a large number of sectors.

66. An important step towards improving the financial sustainability of the environmental sector in EECCA is raising the transparency of public spending. A particular aspect of this action is the need to continue efforts to enhance the transparency of revenues from natural resources and spending such revenues, building on past achievements. The issues of appropriation, distribution and sound use of the natural resource rents need to be addressed.

67. According to the database of the OECD’s Development Assistance Committee (DAC), EECCA is the region receiving the least ODA (after Oceania) – only USD 1.8 billion in 2008. The environment-related ODA accounts for about 19.6% of the total. It is provided through sector aid and traditional project aid. Climate change is the largest single item in the environment-related aid (USD 203.5 million over 2006-2008) of the total environment-related assistance, most of it is received by Kazakhstan, Azerbaijan, Tajikistan and Kyrgyzstan.

68. At the same time, more adequate access to finance and scaled-up investment are important prerequisites for the greening of business and infrastructure in the EECCA region. The scale of change required to shift the development path is such that public funds can only provide a small proportion of the investments needed to enable this change. Policies that involve public expenditures should focus on using public money to leverage private sector investment. Some of these policies involve:

- Including green investments in stimulus packages;
- Using public funds to complement official development assistance;
- Creating incentives for private banks to support environmental investments by providing interest rate subsidies;
- Implementing debt-for-environment swap schemes, as appropriate;
- “Greening” the national stabilisation (wealth) funds;
- Support to the costing of various development scenarios, using financial planning tools;
- Removing possible barriers to flows of foreign direct investment;
- Providing sovereign guarantee for certain loans, etc.

69. Carbon finance, for both mitigation and adaptation, is a potentially important new source of finance for environmental expenditure that EECCA countries need to exploit more consistently. Though to a limited extent, EECCA countries have managed to tap into global climate-related funds. Carbon financing is part of bilateral aid. Some of the international organisations that are active in EECCA, including EBRD, UNDP, or the World Bank help countries to access new sources of environmental finance in the implementation of climate mitigation and adaptation projects through several environmental finance facilities. Such facilities include, for instance, the Global Environment Facility (GEF), MDG Carbon Facility and the joint UN Programme on Reducing Emissions from Deforestation and Land Degradation (UN-REDD).

70. There are examples in EECCA of successful partnerships between development and local banks to provide access to finance in line with green growth objectives. The sustainability of financing schemes that use local banks may however dissipate shortly after the exit of development banks if incentives for local financing of green investments are weak. Costing models and adequate finance needs assessment approaches more generally are required in order to increase the outcomes of spending on green growth projects.

#### **Action area 9: Equip governments to play the role of agents of change**

71. The success of efforts to green economic growth will depend on the extent to which green growth policies are mainstreamed in government policies. If governments wish to take this path, they need to treat the green growth challenges as ones that go to the core of their development strategies. This implies a leading role for finance and economy ministries, or another influential unit (depending upon the country, though in many EECCA countries presidential administration has a particularly strong influence) with a supportive role to be played by ministries of environment. Simultaneously, the weakening of capacity and extreme institutional instability of EECCA environmental ministries need to be contained, and professional staff retain in these ministries. An adequate governance structure will need to be established for ensuring the participation and effective coordination of different players, both governmental and non-governmental. Intra-government coordination will have to address both horizontal and vertical relations.

72. The overall goal should be to integrate green growth into policy processes, rather than create stand-alone policy documents or agencies. On the contrary, a distinct monitoring framework is necessary to measure progress in greening the economy, with a set of indicators that reflects expectations related to green growth but also risks associated with a lack of action on environmental challenges.

73. Mechanisms created in support of sustainable development promotion may need to be re-designed in conformity with lessons learned from their past activity and impact (or its absence). Among other things, governments need to avoid the situation when green growth rhetoric simply leads to the annihilation of sustainable development strategies without bringing any palpable changes. For example, the government of Kazakhstan has already abrogated the country's relatively recent Sustainable Development Strategy to enact a new, green growth strategy.

74. Lately, Medium-Term Expenditure Frameworks (MTEFs) have been introduced in almost all EECCA countries. They added to the planning process a much required element of financial realism. Thus, the overall mechanism for cross-sectoral planning has been established in EECCA. This creates a good basis to address, in a coherent way, cross-cutting policies and environmental policies as part of a wider "green growth strategy".

75. The green growth agenda will have to be very strongly linked to top-priority immediate development objectives such as increased productivity and competitiveness, upgrading municipal services, maintaining or extending export potential, diversification of the economic structure, energy security, job creation, etc. Many countries may be interested in the positive impact of environmental fiscal reform and the removal environmentally harmful subsidies on the state of public finances.

76. No doubt, changing the development path requires careful fine-tuning to the national context and a very broad consensus within society. In this respect, environmental ministries of EECCA countries may want to avoid rushing into green growth preaching and do their "homework" at first. Adopting yet another strategy will bring little change if there is no evidence in support to it or no consensus around it. On the contrary, without due ownership on the side of non-environmental communities, it will become a lost opportunity that is likely to work against green growth.

77. Creating ownership requires analytical evidence that resonates with non-environmental communities. To generate such evidence, ministries of environment may need to invest in skills development and start using tools in support to economic and social analysis of environmental policies. The opposite is true as well: tools of environmental assessment may need promotion within non-environmental communities. The most obvious action is assisting a government-wide adoption of Strategic Environmental Assessment, and extending its use to budgetary programmes.

78. Creating ownership also requires the broadest possible review of constraints and proposed action by various actors, vertically and horizontally – a so-called "360-degree feedback" – including both the governmental and non-governmental sector. Domestic business actors and their associations in particular need to be involved in this type of review: their power and influence in EECCA has evolved significantly since the beginning of transition. More generally, the balance of powers needs to be considered.

79. Policy dialogues involving all relevant stakeholders, and using sound analysis as background for debates, may be used to identify the key constraints to green growth and constructing policy packages to overcome such constraints. Such policy dialogues can accompany the development of framework or sectoral policies, drafting of new laws, or similar "routine" processes. Tools may need to be developed to facilitate such dialogues. International benchmarking and exchange of experience can be useful tools for designing reforms and for a more rapid diffusion of good practices.

80. Finally, without government action to ensure good governance, the entire green growth construction, no matter how soundly designed, will fail. Bad governance erodes confidence among market players in EECCA and makes them focus on short-term high-return projects. A better incentive framework is needed for individuals within the public service to adhere to good governance principles.