

**FINANCING FLOWS AND NEEDS TO IMPLEMENT  
THE NON-LEGALLY BINDING INSTRUMENT**

**ON ALL TYPES OF FORESTS**

**EXECUTIVE SUMMARY**

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## **EXECUTIVE SUMMARY**

The eighth session of the United Nations Forum on Forests (UNFF) will consider “Means of Implementation (MoI) for sustainable forest management.” Given the critical importance of the funding issue for the effective implementation of the Non-Legally Binding Instrument on All Types of Forests (NLBI), the Collaborative Partnership on Forests (CPF), through its Advisory Group on Finance, decided to support substantive preparations for the Ad Hoc Expert Group on finance and UNFF8 through an analytical mapping of needs and available sources and mechanisms for funding, taking into account the recent developments, including in the climate change regime.

The study is intended to provide systematic and objective analysis of the funding sources and gaps vis-à-vis the NLBI. The study focuses on external sources, as adequate information on domestic financing is not available. The study is based on existing global and regional-level sources and databases, as well as a survey among bilateral and multilateral sources of funding. Two concepts are used in discussing the results: (i) forestry ODA, referring to what has been classified by OECD/DAC under support to the forestry sector, and (ii) forest ODA, which also includes support to forest conservation.

### **Financing of NLBI Implementation and Sustainable Forest Management**

The NLBI text provides a set of comprehensive actions to be taken by governments in order to achieve the Global Objectives on Forests (GOF). NLBI national measures and international cooperation may be considered as necessary elements for achieving the GOFs, but they are not sufficient. The outcome will depend on the action to be taken by all forest stakeholders within the framework provided by the NLBI implementation. Financing is a cross-cutting issue in the NLBI. It is specifically addressed in the GOF 4, which calls for reversing the decline in official development assistance for sustainable forest management (SFM) and mobilizing significantly increased, new and additional financial resources for its implementation.

Financing of SFM has proved to be a complex issue due to the dual nature of forest management as it can generate both global and national/local public goods and private profit at the same time; the former from forest-based services such as biodiversity or climate change mitigation, and the latter from timber and non-timber forest products. This duality is both a challenge and opportunity for financing of SFM.

Forest financing sources are classified into public and private, national and international. Domestic public funding may come from general government revenue and revenue from state-owned forests. Private sources consist of forest owners, communities and forest industry, philanthropic funds and donors, as well as NGOs of various types. In the case of many NGOs, funds are raised from external sources. International public sources include bilateral aid agencies and multilateral financing institutions. Private sources are diversified, consisting of institutional and individual investors, forest industry, various NGOs, etc. Foreign private financing can be direct or portfolio investment and loans or credits.

### **Demand for Forest ODA in Recipient Countries**

Country demand for forest ODA is found to be relatively weak, as only two thirds of the surveyed 43 countries mention forests in their poverty reduction strategies (PRS) and only 28% include a coherent national strategy for forests. Forest issues are not yet satisfactorily integrated in PRSs, reflecting weak understanding or low political priority given to forests, or both. Being totally absent in a third of the countries or being treated either in a partial or inadequate manner in a majority of them suggests that effective demand for ODA to forests appears to be limited. This situation reduces opportunities for donor engagement in forests.

It is also apparent that demand for bilateral ODA is also strongly influenced by suppliers' policies. Supported actions are typically strategic areas identified by the recipient country within the

donor's own strategic priorities. In the case of multilateral financing institutions, the situation is somewhat different as they tend to be more demand-driven than bilateral donors. However, multilateral institutions are also influencing the demand by means of analytical work, awareness-raising among their clients, and development of new services (e.g., financing of global public goods).

ODA's role has proved to be mainly catalytic, and it will critically depend on to what extent national forest programmes (nfp) and associated financing strategies can be incorporated in the national development plans and policies. This has become increasingly important as bilateral donors are presently channeling a significant part of their assistance through budget support and domestic systems and procedures. Stakeholders in the forest sector in the recipient countries have to meet the challenge of clarifying and raising awareness of the potential of forests in the achievement of the national development goals. Only a few countries have apparently been able to do this.

A number of countries which have developed comprehensive forest financing strategies (e.g., Tanzania, Guyana, and Viet Nam) have strongly relied on measures to increase revenue generation from the forest sector as a central element to raise funding for SFM. In national strategies in Latin America, the emphasis is generally given to creation of enabling conditions for private investment and developing new innovative instruments, including payment for environmental services (PES) and specialized funds and credit instruments. Less attention has been paid to smallholders, community forests and SMEs.

### **Existing External Sources of Forest Financing**

The current annual bilateral and multilateral flows to forests are estimated at about USD 1.9 billion and the foreign direct investment (FDI) to forest industries at about USD 0.5 billion. Information on private investment by institutional investors, commercial banks and export credit agencies is not available and neither is it known how much the NGO and philanthropy sector contributes to forest financing. The ODA to forests includes about USD 700 million for forest conservation. In addition, the conservation NGOs and philanthropy focus on this thematic area.

In 2000-2007 the combined bilateral and multilateral financing flows have increased by almost 50%, which has partly been a result of increasing engagement of the multilateral sources, as their share of the total external public financing to forests increased from 26 to 42% during the study period. The multilateral sources accounted for three quarters of the total absolute increase in the total. However, bilateral ODA has also increased albeit at a slower rate (15% in 2000-2007). The figures cited should be used with care as the data on external forest financing is incomplete and partly inconsistent.

### **Bilateral ODA**

Bilateral ODA to forests has mainly come from relatively few sources, as 95% is provided by nine donors (Japan, Germany, the European Community, the USA, the Netherlands, Switzerland, the UK, France and Finland). Japan's share overwhelmingly accounts for 48% of the total. Japan's contribution (including forest conservation) increased by 61% in 2000-2007 and, without it, the total bilateral ODA would have declined by about nine percent. Five other donors also recorded some increase in forest ODA and in all the other donor countries the funding declined. The declines are largely explained by reduced allocation to project and programme funding and increasing role of budgetary support which is not allocated by sector. There is also a general trend to consider forests no more as a self-standing priority, but as part of the climate change and other environmental agenda.

Since 2000, two thirds of the cumulative forestry ODA has been allocated to Asia, only 20% to Africa and 11% to Latin America. Asia's share peaked in 2003, when it reached almost 80% of the total. In terms of income level, the least developed countries received 18% of the total and the

other low income group received another 39%. The rest (43%) was channeled to middle income countries.

Bilateral ODA is also concentrated among recipient countries. In 2006, India absorbed 22% of the total forestry ODA, followed by China (13%) and Viet Nam (12%). Together with Indonesia, Cameroon, Tanzania, Bolivia, Brazil, Colombia and Honduras, these ten countries received two thirds of the total forestry ODA, which is therefore fairly highly concentrated.

Although the traditional forestry ODA in the future might not significantly increase or could even decline in some donor countries, funding through new instruments and various international and regional initiatives is likely to increase in the future, probably significantly. A higher proportion of the ODA may also be channeled through multilateral institutions in line with the recent trend. The increased funding will most likely be linked to the broader climate change and conservation agenda. Funding flows through new instruments and approaches are likely to benefit middle income countries more than low income countries. Maintenance of the focus on the least developed countries will therefore be a challenge as many of them are lacking preconditions for effective aid and other external financial flows.

### **Multilateral Sources**

Multilateral financing to forests is estimated at USD 0.8 billion per year in 2005-2007. The main source is the World Bank (WB) Group, and its share in the total has increased from 51% to 73% in 2000-2007. More than half (55%) of the Bank's financing to forests has come from the International Finance Corporation (IFC) in the form of equity and credit to private sector enterprises. GEF's share has been declining, from 31% to 14% during the last six years. Among the regional development banks, the African Development Bank (AfDB) has been the largest source of forest funding (9% of the total multilateral flows). The Asian Development Bank (AsDB) and the Inter-American Development Bank (IADB) have been marginal sources during this decade, while in the 1990s their role was more substantial. ITTO's contribution was 5% in 2001 but it has dropped to 2%.

The other multilateral sources have a volume-wise limited but strategically important role for contributing to financing of SFM. FAO's programmes amount to about USD 48 million/year, including the National Forest Programme Facility. Since its inception in 2002, the Facility has supported stakeholders in 42 countries with grants totaling USD 6 million. The Global Mechanism (GM) of the UNCCD attempts to mobilize funding for sustainable land management in which forest interventions can be important.

### **Private Sector Investments**

There is no systematic information available on the domestic or private foreign direct investment in the forestry sector in developing countries. There is, however, a common view that the bulk of forestry investment is from domestic sources by the formal private sector and by communities, landowners and farmers.

Foreign-induced investment is substantially higher than the recorded foreign direct investment (FDI) flows (USD 0.5 billion per year in 2003-05), as local financing of foreign-owned investment projects is common. The FDI stocks in the wood and paper industries in developing countries have increased rapidly, reaching USD 17.8 billion in 2005. Another recent important trend is FDI made by developing country investors in other developing countries. A significant increase in foreign private financing in developing countries is foreseen in planted forests and downstream industrial processing. Plantation investments are partly made by Timberland Investment Management Organizations (TIMOs), as their risk-averse institutional investors have started to appreciate high expected returns and improved country-level investment climates.

The key issue in private sector financing is to ensure that investments are not made into illegal and unsustainable operations. A growing share of forest industry corporations exporting to environmentally sensitive markets are engaged in Corporate Social Responsibility and have achieved SFM certification or are committed to do it for demonstrating sustainability of their wood supplies. In order to avoid financing of unsustainable activities and to mitigate the reputational, environmental and social risks of forest investments, more than 60 private Equator Principles Financial Institutions have adopted sustainability safeguards in their project finance.

Timberland and other private investors can make a significant contribution to the NLBI national measures in enhancing production of forest goods and services and associated trade. They can also have a positive impact on technology transfer and research, governance and development of human resources. However, only relatively few countries can offer attractive timber-growing conditions, suitable land availability, and adequate investment climate to enable foreign investment to take place. Appropriate regulation and voluntary measures such as forest certification are needed to mitigate possible negative impacts, and to integrate these new actors in the national and local socio-economic framework to maximize mutual benefits.

### **Other Sources**

There are a huge number of other sources of funding on which no consolidated quantitative information is available. While NGOs may often be well equipped to raise funds from these sources, forest communities and smallholders have difficulties in accessing most of them. Albeit being perhaps limited in volume, the non-conventional forest-related financing provides a valuable complement to conventional sources, particularly in the focal areas of education, conservation and research. These sources also address caveats which may not be covered by others, such as innovative and higher-risk projects. Philanthropic sources are already important for financing of forest conservation, and their role could be expanded to address reduction of deforestation and SFM.

### **Emerging Instruments and Mechanisms for Forest Financing**

Great expectations have been put forward concerning the development of payments for environmental services as a possible complementary source of funding for SFM. These expectations have not, however, materialized as yet, as the experience in developing countries continues to be limited (mainly in Latin America). From the international perspective, the PES schemes of global public goods from forests (e.g., climate change mitigation and biodiversity) have been seen as the most promising way to raise additional financial flows to SFM in developing countries.

### **Carbon Offset Markets**

The main mandatory market for carbon offsets, the Kyoto Protocol's Clean Development Mechanism (CDM) has endorsed only one forest project, for the time being. The current forest carbon portfolio under CDM includes a total of 27 projects with a total amount of credits of about 2 million tons CO<sub>2</sub>, suggesting substantial potential demand and supply which has not yet been realized. The voluntary market for carbon credits was USD 331 million in 2007, or more than three-fold the 2006 level. One-sixth of this market was generated by reforestation and forest conservation projects. In spite of small volumes, there is a significant forest carbon offset demand which cannot be channeled through the regulated market. In the short run, this unregulated market is likely to play a critical role in developing new ways of implementation for forest carbon trading.

### **Reduced Emissions from Deforestation and Forest Degradation (REDD)**

Avoiding deforestation would be among the lowest cost mitigation options to avoid increasing CO<sub>2</sub> emissions and possibly also increasing carbon sinks. At the same time, other benefits like

biodiversity conservation, poverty reduction and climate change adaptation could also be enhanced. Through carbon revenue, prospects for the economic viability of SFM in developing countries are expected to substantially improve as at least part of the ecosystem services that forests provide could be remunerated.

REDD compensation as a win-win instrument is being increasingly supported by practically all stakeholders for a variety of reasons. For tropical country governments REDD can represent an opening of a new source of financing for national priorities; for donor countries it can be a low cost option for carbon offsets; for environmental NGOs REDD can generate additional resources for biodiversity conservation; for the rural poor badly needed income and financial support to community development as well as a means to improve their forest tenure rights; for the private sector REDD can be an additional source of funding to make SFM financially viable; for political elites yet another opportunity of income; for multilateral development banks REDD can open up new ways of doing business in the context of maintenance of global public goods; and for intergovernmental organizations it offers a new area of intervention in technical assistance and a new funding source.

Meeting such a broad range of varied interests in REDD schemes will be difficult and several issues need clarification: (i) uncertainty about co-benefits, (ii) risk for violating the rights of indigenous and other local populations, (iii) possible impact on land prices, (iv) equity in distribution of REDD payments, (v) governance arrangements of REDD schemes, (vi) slowness of necessary national-level policy and legal reform processes, (vii) stakeholder participation, (viii) limited access to REDD financing by only forest-rich countries, (ix) possible exclusion of countries which have already addressed deforestation, (x) possible exclusion of drylands and other low carbon intensity forest lands, (xi) definitions and methodologies for treatment of land degradation and restoration of deforested areas, (xii) measures to address underlying causes for deforestation and forest degradation, (xiii) lack of proper understanding on the role of timber harvesting in carbon stock management, (xiv) the level of REDD application (national, sub-national or project), (xv) use of a market mechanism or a fund mechanism, (xvi) possible flooding of the carbon offset markets with REDD credits, (xvii) transaction costs, etc.

Some of the above issues can be addressed through international regulation and some through appropriate measures in national REDD strategies. Many concerns are cross-cutting and need to be considered holistically, e.g., in the context of national forest programmes or similar broader strategies. Independently from which approach is applied, there are additional needs for co-financing of complementary activities to ensure that REDD benefits are created in practice, particularly building up country capacity to implement necessary measures to reduce deforestation.

### **International Climate-Related Forest Initiatives**

Several initiatives have been taken to advance the implementation of REDD-related activities.

- The Forest Carbon Partnership Facility (FCPF) of the World Bank will assist developing countries in their efforts to reduce emissions from deforestation and degradation and building capacity for REDD activities. FCPF's two elements are (1) the Readiness Fund to build up specific implementation capacity in participating countries and (2) the Carbon Fund to finance performance-based payments for REDD offsets. FCPF's target capitalization is at least USD 300 million, of which about USD 155 million has already been pledged.
- Multilateral development banks are in the process of establishing special climate investment funds to assist their members in the implementation of the UNFCCC. The Strategic Climate Fund (SCF) will promote international cooperation through new and additional financing for addressing climate change through targeted programmes. SCF will provide incentives to maintain, restore and enhance carbon-rich natural ecosystems through piloting and scaling up of new development approaches. SCF has a holistic approach to climate change

mitigation and adaptation, which is particularly relevant in the forestry sector due to its diverse opportunities to contribute to the climate objectives. As a measure to start implementing SCF within a broad approach to mitigation of forest-based emissions, enhancement of forest carbon sequestration and adaptive capacity, the World Bank is currently developing a Forest Investment Programme (FIP) which could address the key gaps of SFM financing in the existing and emerging instruments such as REDD schemes.

- The Clean Technology Fund (CTF) is targeted at promoting scaled-up deployment, diffusion and transfer of clean technologies. As regards the forestry sector, investments in bioenergy and improvement of the forest industry's energy efficiency and management fall under the CTF.
- FAO, UNDP and UNEP have launched a joint UN REDD Programme as a collaborative effort to provide coordinated technical assistance in REDD capacity building to developing countries.
- The Collaborative Partnership on Forests (CPF) initiative will elaborate a strategic framework for engaging all the key CPF members for improved cooperation and coordination.
- The International Tropical Timber Organization (ITTO) is planning to develop a thematic programme on tropical forests and climate change.
- Many other international organizations are also developing their own responses to climate change mitigation and adaptation through forest measures (e.g., CIFOR, IUFRO, etc.).

### **Climate-Related Regional and Country Initiatives**

The progress made in recognition of the role of avoided deforestation and forest degradation under the UNFCCC has given rise to several donor initiatives and some developing country governments to provide funding for tropical forest conservation, such as the Congo Basin Forest Fund (CBFF) and the Amazon Fund in Brazil. In the developed countries, e.g., Australia and Norway have launched new financing initiatives targeted at REDD and forest conservation.

There appears to be readiness for action and willingness for financing in climate change mitigation through forest interventions. Many recent decisions by donors will mobilize significant new resources for forest financing even though their total magnitude is still difficult to estimate. Nevertheless, these initiatives, together with various market-based or fund-based financing schemes, have potential to at least double the current financial flows from the international community to forests in developing countries. However, many of them are targeted at the same forest-rich countries which have also been identified as priorities for REDD schemes.

On the other hand, the multitude of initiatives raises the issue of coordination among various parties and funding mechanisms. There is a risk that funding will be driven by the sources and not by demand. Overlapping mandates between initiatives are likely to emerge. There is a need for harnessing synergies between new and emerging financing mechanisms addressing forest-related global concerns, particularly those related to climate change. While harmonization between independent initiatives as an objective may not be realistic and not even appropriate, improved cooperation and coordination is needed based on comparative advantages and available financial and human resources.

### **Payments for Forest Environmental Services Other Than Carbon**

Various regulatory, market-based and other voluntary payment mechanisms for forest environmental services have been introduced over the last decade. They are already a major source of funding in many developed countries for conservation of watershed conservation and biodiversity, but their greatest potential is in developing countries and particularly in climate change mitigation and adaptation. The actual development of market-based PES mechanisms in developing countries has, however, been slow for several reasons, and also, the short and medium-term potential appears to be limited, due to constraints related to the policy and

regulatory framework, market creation and promotion, engagement of suppliers, lack of technical and business management capacities among forest communities and landowners, etc. Payment schemes may therefore have to rely on domestic public sector funding and international support, but in the long run the prospects for market-based solutions appear bright if policy and legal issues can be addressed.

Support is needed to generate (i) realistic understanding of the possibilities of PES schemes, (ii) necessary preconditions for their effective implementation, and (iii) needs for financing of upfront investments in capacity building, information systems, and setting up of appropriate voluntary and regulatory payment mechanisms with intended equity impacts. There are also sovereignty issues to be addressed.

### **Other Emerging Instruments of Forest Financing**

A range of new instruments is being developed to complement the menu of traditional lending and equity investment in the forest sector. These include (i) eco-securitization and forest-backed bonds, (ii) forest insurance and re-insurance, (iii) application of sustainability safeguards, and (iv) corporate-smallholder/community partnerships. These address some constraints, such as upfront financing of long-term forest investments (particularly plantations), and risk management against natural disasters. Eco-securitization and insurance are important strategic instruments which would greatly facilitate private sector investment in forestry but with a few exceptions; they are still at development stage and often need external support.

### **Financing Needs and Gap Analysis**

Due to great variation in local conditions, estimating financing needs for implementing sustainable forest management is difficult. The most comprehensive effort to assess financing needs for the forestry sector has probably been carried out by UNFCCC (2007) which concluded with the following indicative estimates for developing countries:

	<b><u>USD / billion/year</u></b>
opportunity costs for REDD	12.2
sustainable forest management costs	8.2
afforestation/reforestation costs	<u>0.1 – 0.4</u>
<b>Total</b>	<b>21.0</b>

These above estimate for afforestation and reforestation does not reflect the entire potential of this measure in developing countries as it refers only to lands which are eligible for the CDM, i.e., which were not forest in 1990. The total A/R potential is significantly higher.

Notwithstanding the problems related to estimation of financing needs for REDD and SFM, a comparison with the existing financial flows reveals a vast gap in all areas. In addition, the above estimates do not consider investments in capacity building of governments, smallholders, communities and other stakeholders, and other upfront investment costs which would be needed to make forest carbon payments work in practice. Furthermore, climate change adaptation in forests would also require additional financing.

### **Geographic Gap Analysis**

Most developing countries have some ODA flows to forests, but there are 30 countries where no source has been reported. The highest donor presence is found in South and Southeast Asia. Also, Central and South America are relatively well covered by donor participation. Africa as a whole and Western and Central Asia have low levels of country presence by external financing sources.

Many low forest cover countries do not receive substantial external support in managing and conserving their forests or tree resources. Many small or medium-sized countries with still relatively large forests have only limited external support. A number of developing countries with high deforestation rates (above 1%/year) have significant donor presence, but there are a number of them where external support is absent or limited (e.g., Comoros, Mauritania, El Salvador, and Myanmar). Many countries with high or medium forest cover (above 40%) have only limited presence of external financing agencies (e.g., Angola, Congo Rep., Equatorial Guinea, the Democratic Republic of Korea, Gambia, Guinea-Bissau, East Timor, and Trinidad & Tobago). With a few exceptions, small island countries do not receive any support to forests, although their importance in maintenance of biodiversity, watershed protection and adaptation to climate change are often critical.

Some of these gaps are presumably partly explained by political reasons and partly by weak governance which does not allow effective participation of external bilateral and multilateral funding agencies in a complex natural resource sector like forestry, often characterized by strong vested interests resisting any pressures for policy and institutional reforms.

On the other hand, there are a number of countries where external funding sources have a particularly strong presence, such as Indonesia, Brazil, Viet Nam, Kenya and Ethiopia.

Private foreign financing through plantation investments has gone to a small number of countries in Latin America and Asia. Foreign investments in natural forest management are concentrated to forest-rich areas in the Congo Basin, the Amazon Basin and Southeast Asia. Foreign-owned industrial capacity is more broadly invested across countries in Asia and Latin America, but Africa is clearly lagging behind.

### **Thematic Areas**

A considerable share of forest ODA is allocated to forest conservation which is compatible with the principle of supporting enhancement of global public goods. In relative terms, SFM outside protected areas appears to be substantially less supported by external funding. However, these forests also generate important public goods but their maintenance is not compensated to forest managers. New PES mechanisms, particularly REDD, have a major potential in providing financing for SFM, particularly forest conservation.

Financing of forest restoration is likely to remain a major gap, particularly in arid and semi-arid regions due to their low competitiveness for production of wood and NTFPs, as well as for PES schemes due to low carbon intensity, but their potential contribution to co-benefits (other aspects of SFM) is often substantial.

The upstream investment in policy reforms, capacity building and other national measures of the NLBI appears grossly insufficient. PES schemes will not remove this constraint as their focus is on payment upon performance of the environmental service.

Private sector financing will be able to take care of most of the investment needs of productive fast-growing plantation development in those countries which have a comparative advantage and adequate investment climate. Trade-related initiatives like forest certification and the EU Forest Law Enforcement, Governance and Trade (FLEGT) will assist producers to internalize SFM costs in product prices, but this process will take time, as long as low-cost competition continues from illegally and unsustainably produced products and the market share of certified products remains limited.

A whole range of activities are needed to achieve sustained financing of forest management for environmental services and various forest products and services. The long-term scenario should be that these two main income-earning sources could be able to ensure that SFM becomes

gradually self-financing. In order to achieve this goal, new instruments require substantial initial upfront investment to develop and pilot suitable modalities in specific country conditions.

Required investments in areas that are central to SFM implementation (including new instruments like REDD and other PES schemes) include, e.g.:

- (i) Implementation of measures to shift agribusiness companies and landowners away from clearing of rain forests towards planting on non-forest lands, including improvement of agricultural productivity
- (ii) SFM-based production of timber and non-timber forest products
- (iii) Establishment and effective implementation of adequate forest ownership/use rights for communities, smallholders and forest dwellers
- (iv) Land-use zoning and planning in forest areas
- (v) Complementary investments in non-forest sector programs (agriculture, transportation, mining, energy, etc.) to ensure adequate forest protection
- (vi) Building institutional, legal and technical capacities of governments and private and communal forest stakeholders
- (vii) Improving forest governance and forest sector transparency and control
- (viii) Restoration of degraded forest ecosystems and plantations
- (ix) Improvement and restructuring of forest-based industries
- (x) Rural development, social services, and infrastructure, as well as administration and management skills of forest communities
- (xi) Development of innovations and research
- (xii) Implementation of market-based and other voluntary mechanisms
- (xiii) Protection of forests against fires, pests, diseases, and other external threats

### Investment Potential

A qualitative attempt to characterize investment potential in developing countries is given below. It illustrates where future investment in SFM, REDD, afforestation and reforestation (A/R), and forest restoration could be directed.

<b>Deforestation rate/ relative forest cover</b>	<b>Low forest cover countries</b>	<b>High forest cover countries</b>
<b>Countries with high deforestation rate</b>	<b>REDD:</b> high/medium potential <b>SFM:</b> low/no potential <b>A/R:</b> high potential <b>Restoration:</b> high potential	<b>REDD:</b> high potential <b>SFM:</b> high potential <b>A/R:</b> high potential <b>Restoration:</b> high potential
<b>Countries with low deforestation rate</b>	<b>REDD:</b> low/no potential <b>SFM:</b> low/no potential <b>A/R:</b> high potential <b>Restoration:</b> medium potential	<b>REDD:</b> medium potential <b>SFM:</b> high potential <b>A/R:</b> low/medium potential <b>Restoration:</b> low potential
<b>Countries with zero deforestation/ increasing forest area</b>	<b>REDD:</b> no potential <b>SFM:</b> low potential <b>A/R:</b> medium potential <b>Restoration:</b> low/medium potential	<b>REDD:</b> no potential <b>SFM:</b> high potential <b>A/R:</b> low potential <b>Restoration:</b> low/no potential

### Governance Aspects of International Programmes and Financing Arrangements

There are two basic models to partnerships: the shareholder model and stakeholder model. Both theory and practice support the view that a shareholder model of corporate governance may promote efficiency at some cost to legitimacy and that a stakeholder model, while increasing legitimacy, may face collective action problems when the number of participants is large and the cost of organizing diverse interests to pursue a common goal is high relative to the expected benefit. There appears to be an on-going shift in more recent international forest programmes

towards the stakeholder model to improve relevance, ownership, fairness, and accountability, but it is often difficult to balance legitimacy and efficiency.

### **Main Findings**

There is a need for substantial new and additional funding from all sources to support SFM and make the NLBI implementation effective on the ground. While many new promising mechanisms and sources are emerging, so far there is no serious deliberation to define and develop a SFM-specific funding mechanism or instrument.

While ODA for forests appears to have a modest increasing trend in the past few years, the gap between the needs and funding is still very wide. ODA to forests has increased only in the case of few bilateral donors and some multilateral financing institutions. The sustainability of increased ODA is therefore not assured. In order to make progress to achieve GOF4 in mobilizing more resources, concerted efforts are needed from both donor and recipient countries. ODA should play a substantially stronger role in future forest financing. Increased contributions, including to sectoral aid programmes and policy development lending, would be needed in future forest financing to ensure that the financing gap is not expanding further. Due to other pressing priorities in national development, the forest sector in many developing countries will continue to face challenges in mobilizing new public funding for forests. Without explicit linkage with forests in poverty reduction strategies and broader national development plans, there is unlikely to be an increase in explicit demand for (and thereby supply of) ODA to forests. Contribution of forests to poverty reduction and dependency of the poor on forests need further clarification to justify allocation of ODA to forests (including budgetary support).

The Principles of the Paris Declaration on Aid Effectiveness are not yet adequately applied to align and harmonize ODA to forests resulting in high transaction costs both for donor agencies and recipient countries. Only national leadership to coordinate various financing sources and external initiatives can ensure adequate coordination and effectiveness of external public funding to forests.

National forest programmes provide a useful framework for donor harmonization and in-country coordination of external financial support to forestry, but only in a small number of countries they appear to be integrated with broader national development and poverty reduction strategies. There is probably a need to improve implementation of the nfp concept based on the accumulated experience to strengthen the quality of analytical work in the elaboration of nfps and their financing strategies. This would clarify where the gaps are, in order to meet the country-level priorities of SFM and implementation of the NLBI national measures for facilitating mobilization of additional funding.

There are indications that more financing is likely to be available for those countries where there is effective demand for forest financing and where the national legal and policy framework and governance conditions enable investments both by the public and private sectors. It is indeed the national level conditions that will largely define how much external financing will be provided to SFM and associated downstream activities.

Success in raising necessary funding for SFM from private sources will largely depend on (i) the markets for forest goods and services and how forest owners and communities and the other actors in the private sector can be made to invest in sustainable operations, and (ii) whether the competitiveness of forests as a land use can be ensured against alternative uses. In order to achieve this on a country level, there should be a conducive policy environment for SFM, and private sector actors (including smallholders and communities) should have access to adequate funding resources.

Without establishing secure land tenure and forest use rights, it is unrealistic to assume private sector, local communities and smallholders will invest in SFM. Reform processes are politically

sensitive, technically complex and resource-demanding. Implementation tends to be slow, even within an adequate legislation, if the relevant administration cannot be effectively mobilized to implement the will of legislators. This has been frequently underestimated in externally funded programmes and projects to improve land tenure.

Changing the investment climate to provide enabling conditions for both private and public investment as a means to fill part of the SFM financing gap requires addressing both extra-sectoral and forest sector constraints. Addressing the former can rarely be driven by forest sector interests and needs a high-level political commitment. The key sectoral issue in many countries is weak forest governance, which acts as a barrier for both private and public financing. There is a need to assess and monitor national forest sector investment climate to ensure systematic efforts for necessary improvements.

Market-based mechanisms have significant potential to generate financing through payments for forest environmental services, but these mechanisms cannot work effectively without a regulatory framework and the government's promotional role. They also need significant upstream investment, as their payments are made upon performance. This constraint should be addressed when PES schemes are developed.

Appropriate integration of forests into the future climate change regime and its financing instruments will be critical for substantial increase in funding volumes to forests. However, for forest carbon financing instruments to become prevalent, a number of conceptual, policy and administrative complexities (e.g., additionality, incrementality, governance, etc.) will need to be resolved first.

Furthermore, while it is encouraging to note that some forest services, in particular climate change mitigation, have potential to mobilize increased funding for forestry, it is important to ensure that the holistic approach of SFM, including its social, environmental and economic objectives, are not compromised by a narrow focus on a single commodity or service of forests, such as, e.g., carbon sequestration.

The recent experience on biofuels shows that lack of adequate consideration of impacts on society and environment, and equity issues in the design of new financing instruments may backfire. This should be avoided in the case of REDD schemes through adequate analytical work, planning, piloting and awareness-raising to create realistic expectations.

In the design of new financing instruments for filling the existing funding gaps for SFM, there is a need to strive for simple practical solutions which can be improved over time with accumulating experience. Piloting is therefore crucial to allow adequate testing of alternative modalities. Perfection in the initial design of new instruments is often the worst enemy of success.

The main thematic bottleneck is financing of mainstream upfront investment on all aspects of SFM while conservation and capacity building are already covered from a variety of sources, albeit not to a required extent. Access to funding of such mainstreamed upfront investment will be critical in developing countries, so that they can make progress towards a higher degree of self-financing of SFM. This "self-financing" as an objective would be based on revenue generated for forest owners and managers from forest goods and services, including payments for global public goods generated by forests, as appropriate in local conditions.

In view of the existing and emerging financing flows, major geographic gaps appear to be in low forest cover countries and least developed countries. These gaps are strategically important, as significant opportunities for maintenance and enhancement of global and local public goods from forests remain untapped, while the ecosystems of these countries are being degraded. Development of new financing instruments should consider addressing these gaps.

Building up the necessary country capacity would also require additional investment which the current and emerging instruments are not yet sufficiently addressing. For forest actors and other stakeholders as recipients, access to funding sources and transaction costs are crucial. The currently available funding sources have not adequately considered this, as their design is usually driven by internal priorities and procedures.

There is an urgent need to improve transparency of external forest (and related) financing from all sources to developing countries. This has been long overdue and has contributed to the slow progress in reaching a consensus on options to mobilize “new and additional” financial resources for SFM.

### **Strengthening of International Financing for SFM**

There exists a rapidly evolving forest-related financing architecture at the international level, which is partly specifically targeted at sustainable forest management and partly at enhancing the contribution of forests to climate change mitigation and conservation of biological diversity. The ‘portfolio approach’ for forest financing therefore exists, as various funding needs of developing countries for SFM are already being financed from a variety of sources. However, the currently available funding sources are inadequate for SFM due to limitations in focus, availability, accessibility and volume of finance. Further efforts are required to better utilize the existing funding sources and mechanisms, and to expand them by creating new financial instruments to fill the existing gaps.

The international level policy environment related to new funding sources that are targeted at forests, or can support SFM, is constantly evolving. In spite of all existing and emerging financial instruments and sources, with their potentials and limitations, the feasibility of a new “voluntary global financial mechanism” for SFM (as called for by the ECOSOC resolution 2007/40) will continue to be a critical political and policy question. As the currently available funding sources can only address part of the funding needs of SFM and NLBI implementation, the international community should consider whether a specific new SFM/NLBI-targeted instrument or mechanism can be set up in order to increase financial resources in a systematic and predictable manner.

There are several options for new SFM-targeted funding, including those under development. One example is a broad-based forest investment programme along the lines being planned under the Strategic Climate Fund. It could embrace the key multilateral financing institutions and draw on sufficiently large funding flows to be channeled to SFM in developing countries through a variety of instruments, including grants, credits, guarantees, etc. It is however, noted that it is unlikely that one single funding instrument would be sufficient to fully meet the needs of SFM and NLBI implementation.

Various recent funding initiatives related to forests suggest that the tendency is towards more fragmentation rather than consolidation. This is a cause of concern for donors, recipient countries and their beneficiaries, as well as existing international organizations working in the financing area. There is a risk for overlapping mandates, lack of recognition of competitive advantages, confusion among potential providers of funding to new initiatives, and unhealthy competition for ‘good’ projects. There is a need to harness synergies between various financing mechanisms and instruments in climate change, biodiversity, land degradation and sustainable forest management. In view of the independent nature of various financing bodies and sources and the fact that forests are often just one of the financing windows in many cases, it is unrealistic to assume that the various components of the forest financing ‘portfolio’ could be forged under a single management structure. However, effective coordination is necessary at all levels. However that being said, the current cooperative arrangements should be strengthened.

On a country level, enhanced coordination would require integrating instruments such as national forest financing strategies and exchange of information that could be arranged through appropriate arrangements led by governments. In addition, adequate country capacity should be

built up to make full use of the increasingly diversified and complex external and internal funding instruments for forests.

The world's forests are a multi-functional natural resource which, when managed sustainably, can meet the various needs of society in spatial and temporal terms (i.e., local, national, global as well as present and future generations). To maintain and enhance the goods and services provided by forests, international, national and local level action to implement the global commitment to SFM as expressed in the NLBI is paramount. It is equally important that appropriate means of implementation, especially financial resources, for sustainable forest management and thus for the NLBI implementation are made available. Further clarity on how this can be achieved is urgently needed in order to make progress on the ground.