2018 Report of the Arab Forum for Environment and Development

# FINANCING SUSTAINABLE DEVELOPMENT IN ARAB COUNTRIES

EDITED BY:
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**ABDUL-KARIM SADIK**

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ARAB FORUM FOR
ENVIRONMENT AND DEVELOPMENT

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# Preface

*Financing Sustainable Development in Arab Countries* is the topic of the 2018 Annual report of Arab Forum for Environment and Development (AFED). It identifies financing needs, gaps, options and mechanisms, while focusing on sources and addressing enhancement of their roles.

Since 2008, AFED annual reports on the state of Arab environment have highlighted environmental challenges and recommended solutions. One main challenge underscored in all reports was how to finance the recommended changes. AFED's 2011 report on *Green Economy in a Changing Arab World* introduced the concept at the regional level. However, the endorsement of the Sustainable Development Goals (SDGs) in 2015, combined with the provisions of the Paris climate agreement which followed in the same year, demand a new perspective to identify the requirements of financing sustainable development.

AFED's first annual report in 2008, entitled Arab Environment: *Future Challenges*, became a major reference in its field and was the launching pad for the reports which followed, covering nine topics: *Climate Change* (2009), *Water* (2010), *Green Economy* (2011), *Ecological Footprint* (2012), *Sustainable Energy* (2013), *Food Security* (2014), *Sustainable Consumption* (2015), *Sustainable Development in a Changing Arab Climate* (2016) and *Arab Environment in 10 Years* (2017).

The current report has found that Arab countries would need a minimum of USD 230 billion annually to support the achievement of the SDGs. The financing gap in Arab countries with deficit has been estimated at over USD 100 billion annually, comprising a cumulative total of over USD 1.5 trillion through 2030. This does not only call for new funding requirements but also the greening of budgets and the redirecting of existing budgetary allocations from conventional investments to sustainable ones, including addressing climate change concerns. However, the report warns that the price tag is expected to rise much more, taking into account the losses in economic activity due to wars and conflicts in the region since 2011, and the implications of ongoing instability across the region on the implementation of sustainable development goals.

Arab countries need to develop their financing strategies and action plans to support the implementation of the 2030 Agenda. Beyond identifying prospective sources of financing, this implies putting in place adequate laws, policies and regulations to stimulate investments in the right direction. While international cooperation commitments need to be honored, cooperation within the region should be enhanced at all levels. Greater efforts need to be exerted to tap private finance for implementing the SDGs, mainly by creating a sound business environment and implanting confidence in the governance of the development process, under the rule of law and political stability.

The report highlights the need to take immediate action to reverse the current trend in the degradation of natural resources, and adopt policies to maintain their bio-capacity to regenerate their services and support sustainable development.

Apart from securing additional financial resources, the focus should be on the mobilization and the redirection of existing local financial outlays, both public and private, towards supporting sustainable development programs, plans, and activities, which should be executed in a more efficient manner. Corruption should be eradicated, coherent policies enacted, and investor-friendly conditions established. It does not make any economic sense to maintain conventional investment options while at the same time aiming to channel funds to support new and innovative environment-friendly sustainable development path.

AFED wishes to thank all institutional partners who made this report possible: Experts of the UN Economic and Social Commission for West Asia (UN-ESCWA) contributed the overview section, containing the most current data from the Arab region. Other institutions contributed case studies and papers illustrating their work in supporting financing sustainable development in the Arab region, including the World Bank, Islamic Development Bank, UNEP Finance Initiative, OECD, EBRD, OFID and SwitchMed. Special thanks go to the sponsors who supported the production of the report and the annual conference, mainly OPEC Fund for International Development (OFID), Kuwait Foundation for the Advancement of Sciences (KFAS), Food and Agriculture Organization (FAO), Kuwait Fund, and Bank Audi, alongside media partners.

AFED has always stressed the urgent need to invest in people-centered development, which fosters human rights into the sustainable development agenda. Those include the right to development and the principles of genuine public participation, accountability and transparency.

It is hoped that this report will assist in developing adequate policies and plans which help secure the needed financial resources for the efficient implementation of sustainable development goals in the Arab region, based on those principles..

*Beirut, 8 November 2018*

**Najib Saab**
*Secretary General*
*Arab Forum for Environment and Development (AFED)*

INTRODUCTION

# FINANCING SUSTAINABLE DEVELOPMENT IN ARAB COUNTRIES

**2018 Report of the Arab Forum for Environment and Development (AFED)**

The adoption of the sustainable development goals (SDGs) and the Paris climate change agreement in 2015 symbolized a defining moment in international cooperation. They both implied radical changes in the way development is perceived and realized.

In the 2030 Agenda, the world leaders agreed on 17 goals, which embodied an integrated approach to development. The goals, to be realized by 2030, included far-reaching pledges designed to achieve human dignity and better quality of life, while protecting the environment and securing sustainable economic development.

The Paris Agreement established for the first time specific targets to reduce carbon emissions contributing to climate change, inducing a shift to renewable energy and energy efficiency and a change in consumption and production patterns. The agreement also identified milestones to be achieved by 2050. Although the Agreement has its own financing mechanisms, implementation is often intertwined with the SDGs.

Climate change poses a big challenge to Arab countries. The region is among those most affected by the impacts of climate change, particularly sea level rise and drought, which have dire consequences on food production. Equally, Arabs have a vested interest in the implementation of the sustainable development goals; in particular those that help them deal with the interlinked water-energy-food challenges, and goals that foster social and human development in general.

Addressing climate change and meeting the SDGs require major shifts in policy design and implementation, alongside vast investments and non-conventional and innovative financing mechanisms. The gradual shifting and channeling of existing financial outlays to implement the SDGs and address climate change is of prime importance.

It has been estimated that USD 5-7 trillion is needed each year until 2030 to meet the SDGs worldwide. In developing countries alone, the shortfall, or investment gap, is estimated at USD 2.5 trillion per year. The Arab countries would need a minimum of USD 230 billion annually to support the achievement of the SDGs. The financing gap in Arab countries with deficit has been estimated at over USD 100 billion annually, comprising a cumulative total of over USD 1.5 trillion through 2030. This does not only call for new funding requirements but also the greening of budgets and the redirecting of existing budgetary allocations from conventional investments to fund sustainable development, including addressing climate change concerns. Besides this, losses in economic activity due to wars

and conflicts in the region since 2011 have been estimated at over USD 900 billion. Considering the implications of ongoing instability across the region on the implementation of sustainable development goals, the price tag is expected to rise much more.

Public and private financing sources in the Arab region are constrained, and certainly are not at the level of the trillions needed to implement the SDGs. The situation is compounded by the growing political pressure on the transfer of resources from developed to developing countries. In the region itself, disparities govern financing opportunities and challenges among different countries: For the oil-rich countries, financing through oil revenues remains volatile and unpredictable. The budgets of oil-poor middle-income countries that largely depend on taxation revenues are tightly pressed. The tax-to-GDP share of most countries is low, while development priorities regarding sustaining the middle class, poverty reduction and social justice are more pressing than at any other time. Low-income countries have huge development challenges and their baseline is already low given that they have failed in achieving most of the Millennium Development Goals (MDGs). Conflict-torn countries have other challenges related to reconstruction and restoring peace and security, besides achieving the SDGs.

A major obstacle to financing sustainable development is that the Arab region is a net exporter of capital, according to the United Nations Economic and Social Commission for West Asia (ESCWA). For every dollar that enters the region through foreign direct investment (FDI) inflows, approximately USD 1.8 dollars are effectively re-invested abroad, either through FDI outflows or through repatriation of profits earned by investors. At the same time, the region remains a lender to international banks located abroad, as deposits of Arab clients (liabilities) with main international banks outside the region have been persistently higher than the corresponding borrowings of Arab clients from these banks (claims). FDI inflows to the Arab region remain volatile and are concentrated in a few countries and selected sectors, mainly related to the oil industry sector, with negligible inflows to low-income countries.

The Arab region is also a net remittance-exporter; it is both a source and destination for migrant remittances. For every dollar of remittances generated between 2011 and 2016, Arab countries repatriated on average USD 2.8 to other regions. The increased cost of repatriating remittances from and within the Arab region creates significant development finance leakages.

The trillions needed to deliver the SDGs in Arab countries require mobilizing various types of financing instruments. At the public national level, those include investing in priority areas beyond infrastructure, such as human and natural capital, alongside governance as a necessary prerequisite for achieving sustainable development.

Measures that need to be introduced to influence consumption and production patterns to a more sustainable path, while generating income, include the reforming of fiscal policies. This entails reforming the tax system, and introducing subsidy reform package and other incentives that aim at promoting the efficient allocation and use of resources and the equitable distribution of wealth. It also includes designing trade policies that support the achievement of the SDGs.

Foreign financing sources need to be harnessed as well, including official development assistance (ODA) and foreign direct investment (FDI). The United Nations, also comprising funding mechanisms associated to some international conventions, offers another potential source. This report provides a close look into such organizations and conventions, including the World Bank, OPEC Fund for International Development (OFID), Global Environment Facility (GEF), European Bank for Reconstruction and Development (EBRD), and Islamic Development Bank (IsDB). The report also includes an overview of the Multilateral Fund of Montreal Protocol, which represents a unique success story of a global financing mechanism that led to concrete results.

## DEVELOPMENT ASSISTANCE

Arab state donors and their national and regional development institutions have been playing an active role in development cooperation, as an expression of solidarity with other developing nations. Arab bilateral assistance totaled USD 216 billion between 1970-2016, with the bulk of it provided by four countries (Saudi Arabia, Kuwait, the United Arab Emirates and Qatar). The contribution of those countries to development assistance was over 1 percent of their gross national income, which surpasses the target of 0.7 percent set by the UN as level of assistance from developed to developing countries. In 2016, total bilateral assistance provided by Arab countries amounted to USD 13.54 billion, of which one-third went to other Arab countries. In the context of Arab aid, Arab development institutions channeled development assistance to developing countries with a cumulative amount of USD 204 billion as of the end of 2017, 54 percent of which went to Arab countries.

At USD 146 billion worldwide in 2017, Official Development Assistance (ODA) represented a significant, yet small portion of the development requirements. Figures show that total ODA provided to Arab countries from sources outside the Arab region has steadily increased since 2011, following a sharp decline between

2008 and 2010. This resulted in an increase in total ODA to Arab countries in 2016 to USD 22.3 billion, the highest in a decade, and representing a good portion of the global total. However, this numerical increase conceals the fact that up to 15 percent was dedicated to refugee and humanitarian assistance, which is not actually part of development programs.

ODA increased significantly to Syria since 2012, but around 90 percent of it was humanitarian aid. Among the LDCs, Somalia and Yemen received higher inflows of ODA in the past five years, a large part of which was humanitarian aid while ODA to Sudan has declined significantly during the past decade. ODA to the middle-income countries of the region, including Egypt, Jordan, Morocco and Tunisia, increased over the last five years, but aid flow remained volatile, highly fluctuating from one year to another. The inconsistency in the flow of ODA remains a major concern, in addition to the fact that developed countries need to maintain their commitment of 0.7 percent of their national income as assistance to developing countries.

Furthermore, distribution of ODA to the region by sector shows that the share of ODA to education has declined, while the share to health and water supply and sanitation remains negligible at 2-4 percent. ODA share to the production sector declined over the years as well. These trends are worrisome and can hamper the progress of several SDGs in the region, considering that significant resources are needed in these sectors to improve the quality of public services and improve access to the poor in order to make the societies more inclusive and sustainable.

Stable and reliable funding is a critical and indispensable resource for the implementation of the SDGs. In this regard, Arab development institutions are well positioned to extend support to the implementation of the SDGs in Arab countries, within the global partnership reinforced by SDG17, which is the thread that weaves all SDGs together, as it calls for revitalizing the global partnership for sustainable development. Arab development institutions have the leverage to mobilize additional resources for financing the SDGs through co-financing with other development providers. However, for better mobilization of resources, Arab countries need to fully recognize the interconnectedness and complexity of the SDGs, their synergies and tradeoffs, and design integrated strategies with clear and sequenced SDG priorities according to a defined implementation schedule, supported by well-prepared project feasibility studies and sources of financing. This has to be coupled by sound governance and an adequate regulatory framework to create donor confidence.

## PRIVATE FINANCE

Mobilizing the private sector is crucial for addressing the trillions of dollars in investments needed globally to implement the Sustainable Development Goals. Arab countries are not different, as a large share of the financing requirements for supporting sustainable development can only come from the private sector.

Traditionally, the capital markets, and the banking and finance industry in general, have facilitated activities that had a negative impact in the social and environmental context. As evidence of the detrimental impact of climate change grows, the challenges of resource depletion have been laid bare and environmental degradation and social issues have increased, such an approach ceded to be an option. This entails major implications for the financial system.

## UNION OF ARAB BANKS RECOMMENDS TRANSITION TO GREEN BANKING

Arab bankers and representatives of central banks pledged at a forum they convened on 26-29 July 2018 in Hurghada, Egypt, to work together to develop a regulatory framework to encourage the Arab financial sector to actively contribute to financing sustainable development projects. The meeting, organized by Union of Arab Banks (UAB), in cooperation with the Central Bank of Egypt, was held under the topic: Green Banking- the Road to Sustainable Development. AFED presented to the meeting draft of its report on Financing Sustainable Development in Arab Countries, and held consultations on its findings, which were reflected in the recommendations. Here are the full recommendations of UAB Forum:

- Urge central banks to start preparing a regulatory framework for banks operating in the Arab region to take into account the objectives of sustainable development and green banking while practicing various banking activities, with a specific timetable for implementation according to international best practices and standards.
- Form a working group whose members are responsible for the green banking and sustainable development of their institutions and members of the Union of Arab Banks and the associations of local banks to meet periodically to discuss what has been achieved in the field of green banking and sustainable development, as well as identify challenges and share experiences and prepare strategies and future goals.
- Adopt the goal of a shift towards green banking within Arab banks strategic objectives and establish an independent department for sustainable development in each bank.
- Urge Arab banks to develop a training plan to raise awareness among employees about green banking and environmentally-friendly practices in order to encourage them to apply these practices.
- Adopt a mechanism to develop and introduce green products within the Arab Bank's current portfolio, with emphasis on supporting green SMEs as part of the Bank's target groups.
- Encourage Arab banks to support renewable energy projects and environmentally-friendly technologies, and to fully change lighting in all their branches to energy-saving lighting systems, and support the spread of solar-generated electricity systems and encourage institutions and individuals to shift to renewable energy through the provision of funding.
- Urge the Arab banks to continue the efforts in the field of financial inclusion, due to its vital role in the transition to green banking and achieving sustainability.
- Integrate the objectives and policies among banks and other stakeholders in such a way that contributes to achieving the goals of sustainable development 2030.

Nonetheless, challenges for achieving the SDGs and bridging the financing gap can be transformed into a business opportunity: to create new businesses, to cut the cost of impact delivery and to generate economic, environmental and social benefits to society. This is a fertile ground for defining a new set of valuable economic interactions between the public and private sector. The UNEP Finance Initiative calls this an impact-based economy. Moreover, UNEP's Green Economy Initiative advocates a sustainable path for development based on emphasizing investments in human and natural resource capital as the core for achieving human welfare and securing the continuity of growth. UNEP believes that a global transition towards a green economy will require substantial redirection of investments to increase the current level of public and private sector flows to key priority areas, the bulk of which will need to be mobilized through financial markets. Recent years witnessed the start of a shift in the behavior of investors, who are increasingly moving from responsible investment based on a passive do-no-harm approach, to sustainable investment based on actively investing in solutions to sustainability challenges.

It is worth noting that foreign direct investment (FDI) inflows to the Arab region decreased to USD 32.4 billion in 2016, from USD 88.5 billion in 2008. FDI inflows to the region remain volatile, associated with fluctuations in oil prices and political instability. Moreover, profits repatriated by foreign investors and Arab direct investments abroad outbalance the inflows, making the region a net exporter of capital. Reversing this trend requires a regulatory framework that generates confidence and is capable of attracting investors and mobilizing private savings towards supporting sustainable growth.

There is an increasingly exciting array of financing options on the market, from green bonds to blended finance tools. Globally, there has been a 14-fold increase in annual green bond issuing, from USD 11 billion in 2013 to over USD 155 billion in 2017. But while growing rapidly, they are still far from the USD 2.5 trillion dollar annual SDG price tag in developing countries, and certainly very far from the global bond market of around USD 100 trillion. Although green bonds in the Arab countries are still in their infancy, they have started to gain momentum. In 2013, the African Development Bank issued green bonds whose proceeds were partially used to fund two projects in Tunisia and Egypt. In 2017, the National Bank of Abu Dhabi initiated the first green bond issuance in the region for USD 587 million, due in 2022. Blended finance is another innovative form of financing development, based on leveraging development assistance to mobilize additional private finance.

Besides green bonds, Arab countries have started to adopt other forms of innovative mechanisms of financing development, such as results-based financing, used by the World Bank to support the compliance of Egyptian industries to environmental laws. A debt-for-development swap has been used in Egypt, Morocco, Jordan and Yemen. The carbon market, in which carbon emission allowances are traded globally to encourage countries and companies to limit emissions, has been embraced by six Arab countries that indicated national plans to price carbon, but Arab carbon trading activities have not effectively kicked off yet. Five national projects in Egypt and Morocco benefited from financing of USD 281 million from the Green Climate Fund (GCF), dedicated to investments in climate-resilient initiatives. Other Arab states were part of two multi-country projects that received USD 634 million from GCF. Public-private partnership (PPP) has shown poor performance in the Arab region, as private participation in infrastructure amounted to only USD 113.5 billion between 1990 and 2014, which represents a mere 5 percent of the world total of USD 2.5 trillion during the same period.

Tapping the potential of Islamic financing through sukuk (Sharia-compliant bonds) has big potential to fund infrastructure, clean and renewable energy and climate change projects. Another area is to design financial products tailored for expats that can harness remittances into more investment.

## POLICY AND REGULATORY FRAMEWORK

Adopting integrated sustainable development policies is necessary to generate sufficient funding for sustainable development activities. This should be supported by a package of regulatory and market-based measures in order to ensure that the proposed policies, plans and programs are economically and socially equitable, and environmentally acceptable. Regulations that are equally applied to all should not be overwhelmed by restraints and disincentives,

but should also provide incentives to promote sustainable activities and investments. Adopting a transparent, accountable, and participatory approach is necessary for achieving this end. Policies to be adopted include good governance, adequate fiscal space, countercyclical fiscal policies, and measures to combat corruption.

One of the challenges facing several Arab countries is illicit finance flows and money laundering. Efforts should be made to reduce and eventually eliminate these practices, including combating tax evasion by national and transnational corporations. The AFED report suggests that proceeds from fighting corruption in Arab countries would generate up to USD 100 billion annually – enough to bridge the financial gap in investments needed to implement sustainable development goals. As stipulated in the Declaration of the Finance for Development Conference held in Addis Ababa in July 2015, Arab countries should be encouraged to ratify and accede to the United Nations Convention Against Corruption as a means to detect, deter, prevent and counter corruption and bribery, and recover stolen assets to the country of origin. Efforts should be made to introduce regulatory frameworks that increase transparency and accountability of private companies and financial institutions, as well as the public sector.

The Organization for Economic Cooperation and Development (OECD) has developed a range of policy tools to help governments mobilize private finance in support of development objectives and the SDGs. They stipulate that the obstacles facing private investments in development need to be removed, and call for adopting an integrated approach to promote policy coherence. All too often policy objectives are undermined when the actions of different ministries run at cross-purposes, while all public policies, including those covering trade, investment, taxes, competition and development, need to be aligned in support of promoting investment for sustainable development. Even while considering scaling up the volume of finance from billions to trillions, utmost attention needs to be paid to the quality of the investment generated. This is why governments have an important role in establishing good labor, social, and environmental policies, and in promoting responsible business conduct and helping multinationals keep their international value chains clean. This would also ensure that programs and projects are implemented more efficiently, and with greater transparency and accountability.

## PREPARING THE FINANCIAL SECTOR FOR ENVIRONMENTAL RISKS AND OPPORTUNITIES

Climate and environmental risks will have important implications on financial stability. Policy measures to bring down global emissions of greenhouse gasses are needed to restrain climate change and curb the risks associated with it. However, a future where energy is based on alternative sources besides fossil fuels brings an end to many investments and affects valuations. Since large parts of the economy are based on fossil fuels, consequences of the transition could be dramatic, particularly for economies that are heavily dependent on exporting fossil fuels such as the Arab oil countries. However, maintaining the status quo entails larger risks to financial stability. Fortunately, programs to diversify economies have been initiated across Arab oil-exporting countries, accompanied by large investments in renewable energy and energy efficiency as in Saudi Arabia and the United Arab Emirates.

While bank credit provides a big portion of financing, only a small part is explicitly classified as 'green'. According to the European Banking Federation, "lack of clarity as to what constitutes Green Finance activities and products, such as green loans and green assets, represents an obstacle for classification of green assets as well as for identification of further opportunities for green investing." The Federation calls for the adoption of minimum standards and a disclosure framework on green finance. The duty of banks should go beyond reducing the environmental and social impacts of their activities and investments, to providing financial solutions for environmentally-sound projects and programs.

A meeting of the Union of Arab Banks, held in Egypt in July 2018, called for a regulatory framework to encourage the Arab financial sector to actively contribute to financing sustainable development projects. It pledged a shift towards green banking and called upon all Arab banks to establish an independent department for sustainable development, and to introduce green products within their portfolios.

Banking regulators should work with banks to adopt good practices in the management of human, natural and financial resources. Fostering long-term finance is currently constrained by regulatory requirements, challenges to perform sustainability assessment on the long-term, or demand for higher risk and liquidity premiums, thus making projects less viable from an economic and finance perspective. Some of these constraints can be addressed by targeted regulatory or policy decisions which provide incentives to long-term sustainability finance. The clarity and stability of the regulatory environment and public policies are essential for banks to engage in long-term business models and decision-making.

Public entities have to share risks with commercial banks for certain projects that are important for achieving sustainability, while they might not be commercially viable. Incentives, in the form of tax benefits and subsidized funding conditions have to be introduced, simultaneously with phasing-out market distorting subsidies. Monetary policy measures are also necessary, such as accepting certain green assets as collateral for central bank loans.

## CONCLUSION

Arab countries need to develop their financing strategies and action plans to support the implementation of the 2030 Agenda. This implies setting priorities and estimating investment costs and identifying prospective sources of financing, as well as putting in place laws, policies and regulations needed to make available the financing requirements in the short, medium and long term to support sustainable development. For the oil-rich countries, diversification toward non-oil sectors is essential for reducing volatility in revenues and sustaining long term growth. For the oil-poor countries, low tax-to-GDP ratio and the inequity in tax burdens indicate potential for introducing corrective measures in taxation systems, but they need to be rooted in promoting equity and justice as well as supporting sustainable development.

Fiscal reforms in social investments are necessary and, at the same time, countries need to establish fiscal rules that support economic diversification, debt sustainability and long-term stability in growth and revenue collection.

The design of the fiscal system, including the tax system, needs to be geared towards influencing consumption and production patterns towards sustainable development. It needs to be simple and transparent in order to prevent tax evasion and avoidance, and conducive to corruption. Curbing illicit financial flows by better tax administration and cross-border cooperation on taxation is another imperative to improve fiscal space.

International cooperation commitments need to be honored, aid flows need to be kept consistent, and humanitarian aid to refugees should not be deducted from development assistance packages. Cooperation within the region should be enhanced at all levels, including securing inter-regional investments and development aid to finance regional projects, especially in the infrastructure domain where the World Bank estimates that USD 100 billion needs to be invested annually.

Greater efforts need to be exerted to tap private finance as a large pool of resources for implementing the SDGs. Mobilizing savings through better design of financial instruments – that can specifically attract remittances, develop financial markets, attract foreign direct investment by promoting confidence building measures and incentives, and more importantly, reverse the FDI outflows from the region – can contribute significant resources. In addition, countries also need to consider suitable modalities where blended finance such as public-private partnership or other innovative financing mechanisms can deliver public goods and services more efficiently to all.

It is equally important to take action to reverse the current trend in the degradation of natural resources, and adopt policies to maintain their bio-capacity to regenerate their services and support sustainable development. Nonetheless, creating a sound business environment and implanting confidence in the governance of a country's development process, under the rule of law and political stability, are critical elements on the road towards the SDGs.

Apart from securing additional financial resources, the focus should be on the mobilization and the redirection of existing local financial outlays, both public and private, towards supporting sustainable development programs, plans, and activities, which should be executed in a more efficient manner. Corruption should be eradicated, coherent policies enacted, and investor-friendly conditions established. It does not make any economic sense to maintain conventional investment options while at the same time aiming to channel funds to support new and innovative environment-friendly sustainable development options.