LESSONS OF EXPERIENCE

NUMBER 8

The Environmental and Social Challenges of Private Sector Projects:
IFC's Experience

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PREFACE

Development is a complex task, and finding sustainable solutions to complex socioeconomic problems is among the most difficult aspects of international development. IFC invests in over 100 countries, many of which are characterized by high poverty, low levels of industrialization, poor regulatory frameworks, and often the absence of adequate environmental or social standards. For people in these and many other developing countries, battling more immediate issues such as food and basic health care is often the first and only priority; environmental protection or improved social standards may seem like a secondary consideration—even a luxury they simply cannot afford. However, the link between poverty and environmental and social problems is complex and reinforcing. Poverty itself can worsen environmental and social problems, as can poorly conceived or executed development. At the same time, environmental and social problems typically affect the poorest sections of the society the most, making them even poorer. Thus, for example, in some countries, we see mountainsides denuded as the poor forage for firewood, only to see later that the removal of vegetation creates conditions for landslides that injure and kill those very people who live there.

In all its investments, IFC has a well-defined environmental and social approach that it follows, using well-articulated policies, guidelines and procedures. In many cases, the impact of this approach goes beyond the project itself and helps solidify in-country regulations when existing regulations are inadequate, helps countries build their own approach where none existed and contributes to the overall enabling environment. IFC's mission, as defined by the 175 nations that are our shareholders, is to promote sustainable private sector investment in developing countries, helping to reduce poverty and improve people's lives. IFC is convinced that a healthy private sector is necessary to alleviate the abject poverty that pervades much of our world today. Through many years of operations, IFC has sometimes struggled but has slowly come to the realization of how important it is to get things right: that is, finding ways to alleviate poverty as only a healthy private sector can, while at the same time, promoting strong and vital communities and preserving the earth and its resources for future generations.

This review of IFC's experience is intended to share practical experience and, we hope, to contribute to a better understanding of some of the issues involved in sustainable economic, environmental, and social development. The report concludes with an invited piece by Jonathon Porritt, head of the United Kingdom's first Sustainable Development Commission. In his essay, Mr. Porritt outlines his views on how governments and NGOs have evolved in their approach toward environmental and social issues. While we at IFC may not agree with all of Mr. Porritt's views, his is a serious and respected voice in this debate and one that deserves our attention.

Peter L. Woicke
Executive Vice President
International Finance Corporation

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ABBREVIATIONS AND ACRONYMS

BDFIs	Bilateral development banks and financial institutions
BNDES	Banco Nacional de Desenvolvimento Economico e Social
CAO	Compliance Advisor and Ombudsman
CERCLA	Comprehensive Environmental Response, Compensation, and Liability Act
ECA	Export credit agency
EPA	Environmental Protection Agency
E&S	Environmental and social
ESRR	Environmental and social risk rating
EU	European Union
FI	Financial intermediary
GDP	Gross domestic product
GEF	Global Environment Facility
HSBC	Hong Kong Shanghai Bank of Commerce
IDBI	Industrial Development Bank of India
IFC	International Finance Corporation
IFI	International financial institution
IUCN	International Union for Conservation of Nature & Natural Resources
MDB	Multilateral development bank and financial institution
MIGA	Multilateral Investment Guarantee Agency
MSCI	Morgan Stanley Capital International
NatWest Group	National Westminster Group
NGO	Nongovernmental organization
NHUMO	Productor de Negro de Humos Mercados
OECD	Organisation for Economic Co-operation and Development
OEG	Operations Evaluation Group
S&P	Standard and Poor's
SME	Small and medium enterprise
SRI	Socially responsible investing
UBS	Union Bank of Switzerland
U.N.	United Nations
UNEP	United Nations Environment Programme
Westpac	Western Pacific
WTO	World Trade Organization

Note: All dollars are U.S. dollars unless otherwise indicated.

CONTENTS

1 THE ENVIRONMENTAL AND SOCIAL CHALLENGES OF PRIVATE SECTOR DEVELOPMENT

The transformation of the world economy in the course of the twentieth century would have been impossible for even the most acute observer living in 1900 to forecast, or perhaps even to imagine. Output per capita, the structure of production, and the domestic and international financial systems that sustained the growth of economic activity over this period have been altered almost beyond recognition.

World Economic Outlook IMF 2000, p. 149.

The twentieth century saw tremendous, almost unimaginable, changes. Driven by technological progress and growing markets, total world output rose nearly 20-fold, with most of that growth coming about in the last 50 years.[1] Human population also grew during this period, but the growth in output was so much larger that overall output per person rose some 10-fold during the entire century and roughly fourfold during the past 50 years.[2]

The advances in knowledge during the twentieth century, and the tremendous economic growth it generated, have transformed human society. Yet this same growth, while much desired, has also had some unintended consequences. Economic growth varied considerably across the world, resulting in large differences in material well-being between nations. The enormous growth in output has generated an equally dramatic rise in environmental and social (E&S) problems, such as the increased levels of airborne and waterborne emissions, the degradation of entire ecosystems, the depletion of the ozone layer, and the involuntary resettlement of large groups of people.

Human society has attempted to cope with these E&S issues in several ways, ranging from an outright ban on such activities to regulations, taxation, and litigation. Yet the collective response has fallen far short of what needs to be done, focusing only on the most immediate or the most egregious of such problems. A comprehensive societal response to confront these issues has been lacking for a number of reasons. In large part, the societal response is based on what its individual units—its nation-states—do. Nation-states have dealt with these problems differently because of large variations in material well-being, political systems, and cultures, which dictate their economic, environmental, and social priorities.

The focus of this volume is on one aspect of this far-reaching debate: E&S issues in the context of private sector projects. Specifically, it reports on the International Finance Corporation's (IFC's) experience in addressing E&S issues while financing private sector projects.

Environmental issues are defined here as those that have an impact on the physical environment, and thus on its inhabitants. These can vary widely, from localized events, such as minor spills, to those with global impacts, such as greenhouse gas emissions. Social issues are influenced by the culture, mores, ethics, and preferences of communities and societies. For the purposes of this study, we consider only social issues that affect communities where IFC-financed projects are located. Examples of social issues include involuntary resettlement, potentially adverse impact of a project on indigenous peoples, cultural property, and forced and child labor. Again, some impacts are local, while others are more widespread.

While many players are involved in private sector projects in developing countries, the following five groups play a particularly important role:

- Private sector firms
- Private financial institutions
- Public international financial institutions (including IFC)
- Governments
- Nongovernmental organizations (NGOs).

This publication focuses on one international financial institution: IFC. It traces the evolution of IFC's involvement in E&S issues and highlights lessons from its experience in incorporating such issues into projects financed in the 1990s. IFC's approach toward environmental issues has evolved over time, influenced by at least five, not wholly unconnected, forces. First, as new and increasing scientific evidence on environmental issues has improved overall understanding of the subject, IFC has attempted to reflect these findings in its guidelines, policies, standards, and procedures.

IFC has attempted to learn from projects where it made mistakes because of a lack of precedence, an absence of clear understanding of the issues, or otherwise honest but unintended actions.

Second, IFC has looked to and been influenced by changes in benchmark regulations, such as those of the United States and the European Union (EU).

Third, IFC has attempted to learn from projects where it made mistakes because of a lack of precedence, an absence of clear understanding of the issues, or otherwise honest but unintended actions. In such cases IFC has investigated the issue, responded with changed or new processes and procedures, and put systems in place so that these mistakes will not be repeated.

Fourth, at the same time that IFC began systematically considering E&S issues in projects (roughly 1989–95), the world witnessed tremendous political change in the form of the collapse of communism and a quantum leap in privatization. As countries opened up their economies to new players, closed down or privatized state-owned enterprises, and allowed private participation in infrastructure, IFC's focus was on helping make these transitions as effective as possible. Responding to the enormous demand, IFC's emphasis was on ensuring that projects were financially viable and profitable; E&S considerations played an important, but secondary, role. As the transition wound down, or at least became mainstream, the importance of other considerations, particularly E&S, grew significantly.

Fifth, the NGO community played a critical role in influencing IFC to make its own transition to a stage where projects' E&S considerations have become as important as financial profitability (for more on the role of the NGO community see chapter 7).

As with environmental issues, IFC's engagement in social issues has also evolved over time. Three aspects of IFC's engagement in social policies bear mention. First, IFC is a public institution and has a developmental role. Any IFC investment in a project comes from public money and should leave communities better off than they were prior to the investment.

Second, IFC looks to other international institutions, benchmarks, and standards, such as the World Bank, the International Labour Organisation, and ISO 14001 to improve its understanding and inform its approach.

Third, since its founding in 1956 IFC has invested more than $31 billion of its own funds and has arranged $20 billion in syndications and underwritings for 2,636 companies in 140 countries. This extensive engagement has placed IFC in many frontier markets, positioning it

as a participant in complex developmental issues, and permitting it to observe nations working through difficult tradeoffs in relation to such issues. These experiences have influenced IFC's perceptions of, attitude toward, and engagement in a number of fronts, including E&S issues.

IFC's involvement in both social and environmental issues will continue to evolve as its awareness and understanding of the issues improves over time.

The next chapter traces how three key sets of actors—private businesses, private financial institutions, and public financial institutions—have evolved in their own involvement in E&S issues. In an attempt to give readers a sense of the issues involved and to highlight important initiatives by each group, the discussion is selective and biased toward positive examples. The report then focuses primarily on IFC. Chapter 3 presents an overview of IFC's E&S management system, describing the evolution of the consideration of E&S issues within IFC and focusing on the development of policies, guidelines, procedures, and standards.

The core of this study lies in chapters 4 and 5. Chapter 4 presents some broad lessons IFC has learned in dealing with E&S issues drawing from a number of sources, including individual project reviews, internal and external surveys, and supervision reports. Chapter 5 describes a variety of IFC's environmentally and socially beneficial projects, drawing on a database of some 75 IFC projects in this area. As both chapters show, IFC is moving from its earlier "do no harm" approach to a "do good" approach.

Chapter 6 looks at some important unresolved issues in the E&S arena, especially where IFC is going on these and other E&S issues and some important priorities for the years to come. Chapter 6 also discusses some critical, yet unanswered, questions in the area of E&S issues.

The volume concludes with an invited piece by Jonathon Porritt, head of the United Kingdom's Sustainable Development Commission, where he outlines his views on how governments and NGOs have evolved in their approach to E&S issues.

[1] All references to world output are in constant dollars—that is, inflation-adjusted dollars—to allow for comparisons over time. The terms world output, world real gross domestic product (GDP), and world GDP are all used interchangeably in this chapter.

[2] This brief discussion of world GDP growth during the twentieth century draws upon IMF (2000, chapter 5), as well as on data and discussion in Delong (n.d.). World GDP estimates of $2 trillion, $5 trillion, and $38 trillion for 1900, 1950, and 2000, respectively, are conservative, and essentially do not account for the vast changes in the numbers and types of goods and services available to consumers today. Delong provides alternative estimates of world GDP that attempt to account for this bias, which put world GDP for 1900, 1950, and 2000 at $1 trillion, $4 trillion, and $41 trillion, respectively. While his estimates suggest that growth in the second half of the twentieth century was even more dramatic, the essential point is the same.

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2 KEY PLAYERS AND ENVIRONMENTAL AND SOCIAL ISSUES IN PRIVATE SECTOR FINANCE

In 1992 one-third of all airborne particle pollution in Estonia came from just one source: a cement factory in the northeastern coastal town of Kunda. A thick haze of cement dust hovered around the factory, and the ground around it could not support plant life, earning Kunda the nickname "the gray town."

Today, the air has cleared and greenery has returned to Kunda. The cement works were restructured into Kunda Nordic Cement, a modern, efficient, and privately held enterprise, even as Estonia began its difficult economic transition from a centralized economy. Kunda Nordic Cement installed highly effective technologies, yielding environmental benefits for Kunda and the entire Baltic region.

By the time the Soviet Union dissolved in 1992, the site had seen continuous operations for 120 years, with large-scale cement manufacture since the 1940s. The plant had not benefited from any major renovation since the 1960s, and the use of old equipment resulted in more than 82,000 tons of dust emissions a year, as well as high levels of sulfur-dioxide and nitrogen-oxide emissions, leading to adverse health effects on both people and livestock in the area, soil degradation, and water pollution that reduced catches by local fishermen. To address this problem, the plant installed new equipment that cooled the cement after production, thereby reducing dust emissions by more than 98 percent of the 1992 level, to just over 1,000 tons per year. The benefits of this improved air quality extended throughout Estonia and as far away as Belarus, Finland, Norway, Poland, Russia, and Sweden.

IFC helped fund the new energy-efficient equipment and assisted with developing facilities for wastewater processing and a landfill for kiln dust. As part of a separate but related project, IFC participated in the construction of a port facility and associated infrastructure in Kunda in 1993, leading to crucial savings in the cost of transporting the cement.

By 1998 this new port was handling approximately 15 percent of Estonia's exports. Trade—a higher-margin activity than cement production—has become a permanent part of the local economy.

By revolutionizing its operations in just seven years, Kunda Nordic Cement now stands as a model of how to produce for the market effectively while also safeguarding the environment. Had the Kunda factory failed to change its operations in 1992, environmental and business concerns would probably have forced management to close the plant. Instead, the plant has continued to produce cement at the same level as during the Soviet era, to pay salaries to local workers, to purchase goods worth an average $5 million per year, and to contract an average of $3 million per year in services. At the same time, reduced dust emissions have made the town cleaner and reduced metal corrosion, improving Kunda's public image and attractiveness to investment and tourism (for a cost-benefit analysis of the project see box 2.4).

The Kunda example illustrates how the private sector can effectively harness market forces in the service of E&S improvement. That is a theme of this chapter, which focuses on the private sector actors that play a central role in the E&S debate, namely, private producers of goods and services; private financial and funding institutions; and public financial institutions, such as IFC, that invest in the private sector.

This discussion is not intended to be an exhaustive and balanced literature survey of all relevant E&S issues pertaining to the private sector. The intention here is to highlight selected developments in the private sector where firms, industry associations, or other organizations have made progress in addressing E&S issues, primarily on a voluntary basis. Given this selective focus, the discussion is biased toward positive developments.

In practice, the track record of voluntary initiatives in the E&S area—that is, in self-regulation—has been mixed. Often firms and industry groups have aggressively resisted addressing E&S issues, capitulating only to legislation, lawsuits, intense public opinion, or some combination of the three. In virtually every industry, individual firms tend to vary in their approach toward E&S issues. Sometimes the same firm has had widely changing, even contradictory, approaches toward different environmental or social issues or toward the same issue over time. The more forward-looking firms tend to learn from their experience and work to turn adversity into sources of competitive, strategic, reputational, and economic strength. Such firms typically represent the leading edge of their industries rather than the average.

Of the many players involved in financing private sector projects in developing countries, three groups play a central role. The first group, private producers of goods and services, is extremely diverse and varies enormously in terms of size, ranging from large, transnational corporations to small and medium enterprises (SMEs). The former include corporations such as General Electric, IBM, and Shell, with multicountry (often multicontinental) operations, thousands of employees, and annual revenues of billions of dollars. SMEs, by contrast, typically have localized operations, few employees, and relatively small annual revenues.[1] This study includes all firms that produce goods (that is, manufacturing firms), as well as firms that provide services. Among service providers, those in sectors such as retail, construction, hotels, and tourism are likely to be the ones with significant E&S issues (see box 2.1).

The second group, private financial and funding institutions, is also diverse and large, and comprises the banking, insurance, and fund management sectors. Until recently, this group has focused predominantly on financial issues. However, events during the last two decades have raised the importance of E&S issues for this group.

The last group consists of public sector institutions that provide financing to the private sector. While national development banks such as the Banco Nacional de Desenvolvimento Economico e Social (BNDES) in Brazil and the Industrial Development Bank of India (IDBI) are large players in this group, the focus in this

chapter is on multilateral, bilateral, and export credit agencies, collectively referred to as international financial institutions (IFIs).

PRIVATE PRODUCERS OF GOODS AND SERVICES

Until the late 1960s or so, private producers of goods and services did not engage in E&S matters to any significant extent. Since that time, this group has been inexorably drawn into dealing with E&S issues driven by a combination of push and pull factors. On the push side, a series of environmental incidents, some of them disasters, spurred an onslaught of actions against the perpetrators, and thus the industries to which they belonged. Such action ranged from lawsuits to the promulgation of new laws and regulations that prevented such firms from behaving as they had in the past. On the pull side, factors included a slow, but growing, recognition that E&S issues were here to stay, and that by embracing them corporations could receive a number of advantages. These advantages included cost reductions in their production process and operations and enhanced reputations (with a corresponding positive impact on profitability), and led selected firms to deal with E&S issues voluntarily and willingly.

Two environmental disasters played a particularly important role in influencing public views on corporate environmental issues. In 1984 a leak at Union Carbide's pesticide plant in Bhopal, India, released large amounts of methylisocyanate into the air. Within hours of the explosion some 2,000 to 8,000 people had died and another 100,000 to 500,0000 suffered injuries. Survivors continue to be affected today. Then in 1989 the Exxon Valdez oil tanker spilled about 11 million barrels of crude oil in Prince William Sound, Alaska. Roughly 400,000 birds and 4,500 marine mammals perished, and more than 1,200 miles of coastline were despoiled. These events generated enormous concern, significantly raising societal demands to tighten environmental regulations.

Among the consequences resulting from the Bhopal disaster were new requirements for United States-based multinational chemical companies to improve their management systems and to report any releases of pollutants into the environment.[2] This, in turn, resulted in significant growth in the openness and accountability of companies in environmentally sensitive sectors, although not as much as some of their critics might have wished. The Valdez spill prompted the creation of the Valdez Principles, which laid out new standards of corporate E&S responsibility. Later renamed the CERES Principles (named after the Coalition for Environmentally Responsible Economies, an unusual mix of campaigners and ethical investors who drafted them), these became an important influence on the debate about environmental responsibility.

Following directly from the CERES Principles came the Global Reporting Initiative. Founded in 1997, its members include such companies as Novo Nordisk, TetraPak, and UBS; various professional associations; and the United Nations Environment Programme (UNEP). In early 2000 the Global Reporting Initiative ran a pilot test with the ultimate objective of elevating corporate reporting practices to a level equivalent to financial reporting, using standardized reporting guidelines to reflect the economic, environmental, and social dimensions of sustainability.[3] Despite a marked increase in the number of corporations showing interest in the Global Reporting Initiative and other similar ventures, the movement is still at an early stage.

Private Firms' Response to E&S Issues

Private firms have responded to E&S issues in a wide variety of ways. How a firm reacts to such issues depends on a number of factors, including the firm's circumstances, capabilities, and strategy; its position in the market; and industry economics (see Reinhardt 2000). A firm that is doing extremely well financially, is the industry leader, and has strong technical and managerial capabilities would probably react quite differently from a small firm struggling to survive in a highly competitive industry. For the sake of simplicity, the discussion that follows groups firms' responses into four categories, with the full recognition that, in practice, few firms fit neatly into any one box.

Private businesses have a number of choices to make in terms of the products they produce; the technologies, processes, and inputs they use; the locations where they site their businesses; the employment and labor practices they use; and so on. Traditionally, businesses tended to make choices to maximize profitability, often in the short run, and in many parts of the world they still do.

Box 2.1 Industry Initiatives on E&S Matters

Some of the early private sector players to be involved in E&S issues were those engaged in projects that had a large-scale impact on the natural environment or those engaging in manufacturing hazardous substances. These included international oil, mining, and chemical companies, which typically had operations in numerous countries. Given the large scale of their operations, these companies were highly visible. Environmental disasters, consumer boycotts, new environmental regulations in host countries, and the adoption of internal standards were key drivers behind company action.

Oil and Gas
Oil companies have historically had a spotty record on E&S issues. The industry's early history is characterized by a number of E&S incidents, including oil spills and the public perception that the industry was linked to groups engaging in human rights abuses. In recent years a number of major oil companies have recognized the importance of issues such as climate change and global warming. Companies such as BP, Enron, and Royal Dutch/Shell are investing considerable resources in hydrogen storage, solar power, cogeneration, wind energy, and the like. Firms are also pursuing innovative approaches in directly tackling greenhouse gases. For example, BP has established an internal emissions trading system, whereby individual business units of BP can trade emission permits among themselves to meet a corporate goal for greenhouse gas emissions.

Chemicals
Driven by rising public concern about the manufacture and use of chemicals, United States-based chemical companies took their first concerted industry action in 1988, leading to the Responsible Care initiative. Now a fairly extensive set of performance goals and measures guiding 46 members based predominantly in countries of the Organisation for Economic Co-operation and Development (OECD), the initiative includes principles and code of practices geared toward raising the health, safety, and environmental performance of member companies.

Mining
Along with the oil and gas industry, mining has historically also had a poor reputation in relation to E&S issues. In 1991 a number of the world's largest mining and metal companies formed the International Council for Minerals and the Environment. In 1998 nine mining companies launched a second initiative, the Global Mining Initiative, to better understand sustainable development and its links to mining. An independent assessment of the issues facing the mining industry, the Minerals, Mining, and Sustainable Development Assessment, is currently under way.

Hospitality
Firms in the hotel and hospitality sector have had a history of being engaged in E&S issues. Through a number of forums, such as the World Travel and Tourism Council and the industry trade magazine Green Hotelier, the industry has focused on a variety of E&S issues. Certain firms have taken steps to improve building design and construction, minimize the consumption of water and other resources, deal with local social and labor issues, and, more recently, pursue eco-tourism.

Retail
Consumer concerns about such issues as environmentally friendly products and packaging and sweatshop labor have driven the retail industry's involvement in E&S issues. In 1998 the U.S. apparel and footwear industry formed a nonprofit organization, the Fair Labor Association, to provide external assessment and verification of agreed codes of conduct in relation to E&S performance by corporations in the group, starting in 2000.

Automobile Industry and Road Transport
Since the 1970s this sector has made fundamental improvements in at least three areas that affect the environment: emissions, fuel efficiency, and materials. While most such changes originated in countries of the OECD, driven by health concerns and globalization, these issues are spilling over to developing countries. For example, rising concern about blood lead levels led Thailand to move to unleaded fuel. Similarly, globalization has led to the spread of improved emissions control technology as Western companies establish plants in developing countries and developing country automakers attempt to export to lucrative Western markets.

The auto industry has been engaged in a number of initiatives on various E&S issues, such as the Global Reporting Initiative, the Business Environmental Leadership Council, and joint efforts to develop vehicles with significantly higher fuel efficiencies and develop fuel cell technology. Individual auto makers are either globally ISO 14001 certified or moving in that direction. In some cases they require their suppliers to be ISO 14001 certified as well.

Notwithstanding these important initiatives by major Western automakers, pollution resulting from road transport remains an enormous problem in many developing countries, with at least four significant dimensions: the use of leaded fuel, the widespread use of diesel with a high sulfur content, high levels of auto emissions, and the continued usage of outdated technology in motor vehicles. To address these issues in developing countries, governments, the private sector, and civil society will need to work together.

These choices also affect the E&S sustainability of their projects. In some cases, such as eco-efficient production, profitability and E&S sustainability go hand-in-hand and produce a win-win situation. In such cases businesses can help the environment while helping themselves. In other cases, however, businesses are faced with a tradeoff between profitability, typically short term, and E&S measures, where benefits are typically longer run, but costs may be immediate. For example, in situations where mitigation is costly, but is not required by law, firms may opt not to address the specific E&S issue. Thus the various options available to businesses could be viewed in terms of a simple matrix, with profitability along one axis and E&S sustainability along the other (figure 2.1).

Regulation, when it works well, tilts the balance in favor of favorable E&S outcomes, making otherwise profitable activities costly through fines, shutdowns, and other punitive steps. Public pressure also tilts the balance, given that a firm's reputation typically affects its bottom line, and thus activities that hurt a firm's reputation, such as poor labor practices, reduce its profitability. Businesses thus face a strategic choice: how and where to position themselves on the matrix. The four firm categories in the matrix are as follows:

- **Proactive.** Such firms actively seek out processes and technologies that offer win-win solutions. They typically have well-designed E&S management systems in place. More often than not, they are strategically led, well-managed companies that look at long-term, sustainable outcomes. Their approach adds value to their operating margins; protects, or even enhances, the environment; effectively incorporates social issues with socially beneficial outcomes; and improves their corporate reputation.
- **Reactive.** Firms in this category comply with the letter, if not the spirit, of regulations. They are aware of the need to mitigate the E&S impact of their activities, but tend to be more concerned about other issues. Such firms typically deal with E&S issues with an "end of pipe" solution, without adapting the underlying processes and technologies. Their approach does no harm, but they are likely to miss opportunities to do good, both for themselves and for the community around them. This approach tends to be costly and time-consuming. It is a small win for E&S, because these firms comply, but their approach typically has a negative impact on their bottom line, and is thus a loss for profitability.
- **Minimalist.** Firms in this group focus on maximizing profitability, which includes doing just enough to stay on the right side of the law (as enforced). This may be a win for short-run profitability, but it is a loss for E&S.
- **Unsustainable.** Such firms use processes and technologies that are neither cost-effective nor E&S friendly. Such a situation is not only bad for the environment and for society, but also exposes the enterprise to compliance and clean-up costs (often significant), future liabilities, and in some cases damage to its reputation. This outcome is a lose-lose on both E&S and profitability grounds.

Businesses choose to be in either of the lower two boxes, both of which entail a loss of profitability, for a number of reasons. These include capital constraints (they are unable to invest in better technology), knowledge constraints (they are unaware of better ways of doing things), or capacity constraints (they do not have the time or staff to think about these issues or assess the costs of their E&S impacts). When IFC works with such firms, one of its objectives is to help them move

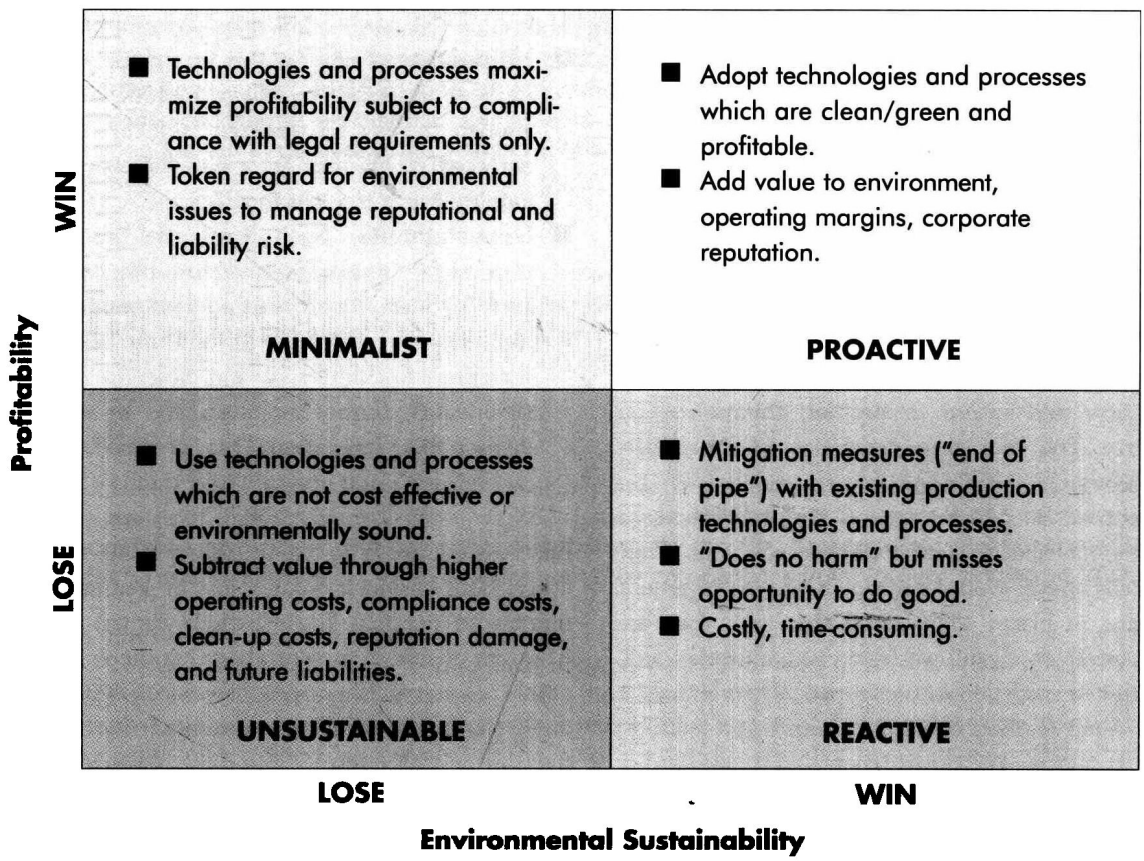
out of the lower half of the matrix by providing finance, knowledge, and technical assistance to alleviate constraints in those areas. Given the number of firms that require such help and the limited amount of financing that IFC and similar institutions bring to the table, IFC can work with only a small fraction of those that need such assistance. However, by helping a few firms, IFC's hope is that competitive pressure will push other companies in the industry or region to change their way of doing business or exit the market. This is particularly true of companies operating in countries where national E&S requirements are less stringent than IFC's. In a number of cases, IFC investee firms are ahead of their domestic competitors on E&S issues. They are therefore well-positioned to take advantage of new opportunities without any additional expenditure, and may be able to take the lead when, for example, a country strengthens its national E&S requirements or the firms expand into export markets such as the EU. By contrast, many domestic competitors faced with these opportunities are forced to incur significant expenditures or shut down (for examples see chapter 4).

Projects like these reinforce IFC's role in encouraging companies to move from the minimalist to the proactive cell in the matrix by raising their awareness of E&S issues, emphasizing the opportunities of adopting a proactive approach to E&S issues, and highlighting the potential payoff from such a move.

Interindustry Initiatives

A number of E&S issues have such broad ramifications that governments are unlikely to be able to tackle them entirely on their own, for instance, greenhouse gas emissions. Instead, businesses will almost certainly have to play a more active role, and some large corporations have already begun work in this area. For example, in line with the Kyoto Protocol (box 2.2), a number of large

Figure 2.1 Environmental and Social Issues and Businesses: Alternative Approaches



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