



## POLICIES AND INSTITUTIONS: ENABLING FACTORS FOR PES

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USAID PES Brief 5

### Authors

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### Introduction

This brief examines policy and institutional issues that are important for PES. It addresses various aspects of the local policy environment, institutional issues related to property rights, collective action, and issues of public sentiments and norms that may influence the feasibility of a PES approach.

Institutions refer to both the formal and informal rules and norms that govern human interaction. Examples of institutions are laws, markets, property rights, and unwritten social norms, and of course they play an important role in developing PES mechanisms, enabling them to function, and ensuring that they help or do not hurt poor people's interests.

### Property rights

**Property rights as a prerequisite for PES.** Property rights play an essential role in payment for environmental service schemes. Environmental services emanate from land use, and payment for environmental services involves paying land managers to utilize the land in ways that provide the desired environmental service. Because PES arrangements are contractual and because they typically require land-use changes over the long term, they normally require an arrangement with the landowner. If land rights are unclear, it is difficult to identify service providers who can guarantee provision of environmental services in exchange for payment. This helps explain why, for example, only landowners are eligible to participate in Costa Rica's national PES program.

In principle, PES arrangements could be undertaken with communal land holders if the communal land holders can credibly provide environmental services. In fact, group-based PES mechanisms help reduce transaction costs associated with setting up and enforcing contracts with large numbers of smallholders. In such a case, a significant portion of the transaction costs are borne within the communal group as opposed to between each individual provider and buyer. The transaction costs among group members may be more or less manageable depending on the context and the characteristics of the group. One potential problem would arise if payment for the service is made in cash, for there is potential for the payment not to be distributed fairly. If the payment or reward comes in some indivisible form that benefits all local people, then this is not an issue.

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Various scenarios can be imagined when property rights are insecure but a PES arrangement is desired. It could be that the demand for environmental services could stimulate an effort to strengthen property rights systems to facilitate environmental service agreements. On the other hand, if poor people manage land without clear property rights, the prospect of PES could make the land more valuable and lead more powerful people to claim the land. For example, large landowners might evict tenants who are farming and convert the land to forest or other land use that is eligible for PES. Similarly, powerful groups may acquire previously unattractive common lands that poor people depend on to obtain PES payments. Such problems have been encountered in programs that rehabilitate common lands in India. Also in India, often community lands such as forests and pastures are under the jurisdiction of government departments or local governments. Usually a community has access to use such lands for non-commercial benefits. However, if the land becomes more valuable (e.g., due to carbon plantations) governments may reclaim ownership and the community may lose access.

**Property rights as the reward.** In many areas of the world, the state claims rights over land on which inhabitants are regarded as illegal squatters, even if they have been on the land for generations. In such cases, it is possible to offer land users secure land tenure as a conditional reward for providing environmental services, either in place of or in addition to cash payments. In Indonesia, a social forestry program known as HKm (its acronym in the Bahasa Indonesia language) provides groups of land users with potential tenure in exchange for protecting patches of natural forest and providing watershed services. Similar efforts have been made in the Philippines and in forested areas of eastern India where shifting cultivation is practiced. In Indonesia, HKm groups are granted initial five-year probationary permits followed by renewable 25-year permits if they meet program requirements. One concern about such an arrangement is that, while the threat of revoking land tenure rights may be realistic in the early years, after 25 years the threat of eviction may not be politically plausible. For that reason, some observers have suggested that other reward mechanisms could be tested that are more easily revoked, such as a bonus to the local government budget for providing public services. .

**Environmental service agreements create new property rights.** Property rights generally are limited. Often the rights to use privately owned land come with the responsibility to use it in socially acceptable ways. PES arrangements may change the bundle of rights and responsibilities associated with landownership. In particular, PES is contrary to the long established “polluter pays” principle, which says that people have the right not to be subjected to pollution. A PES arrangement, on the other hand, implies that land users have the right to use the land as they please, and if others do not like the negative externalities that this land use imposes, they must pay the land user to change his or her practices. The logic behind such an arrangement is twofold. First, long-established land uses may have incremental, offsite effects that become a problem only as the numbers of both land users and environmental service users reach critical thresholds. In such cases it seems fair that long-established behavior should not suddenly become outlawed. Second, in many cases restricting certain types of land use is often unenforceable and create animosity with local land users. Still, there is a grey area in trying to determine when land users should be rewarded for providing an environmental service and when regulations can be used to prohibit pollution producing activities.

## **Social norms**

Offering payment to ensure that essential environmental services are provided is a revolutionary change. The idea of paying for what has always been available free of charge may strike some consumers as distasteful or unfair. As discussed earlier, PES appears to turn the polluter pays principle (PPP) on its head. Under PPP, people have the right to expect environmental services and a landowner who pollutes the environment must pay a penalty for disrupting that right. Under PES, the landowner

has the right to pollute and may continue to do so unless offered a sufficiently high payment to encourage a change in land use.

Establishing a cultural acceptance of willingness to pay for essential but increasingly scarce environmental services will be required before PES can spread very far. Most likely such acceptance will spread with the increasing scarcity of certain environmental services and the understanding that they cannot be taken for granted.

## **Laws and PES**

Changes in laws can facilitate the development of PES mechanisms, which in turn have their own legal implications. A good example is the Kyoto Protocol, which made carbon emissions reduction mandatory in signatory countries, unleashing demand for carbon credits. Kyoto allows only limited carbon credits from carbon sequestration, but if this limitation were relaxed, large numbers of landowners in developing countries would be eligible to receive payments for carbon sequestration.

A corollary point is that PES mechanisms may work in tandem with other approaches to environmental management while in other cases PES may be instituted in place of a regulatory approach. For example, the Kyoto Protocol facilitates payments for carbon credits because a regulatory mechanism created the conditions that stimulated demand for PES. Other legal issues will certainly arise, such as the need for mechanisms to ensure that contracts are honored by both buyers and sellers, and systems for dispute resolution.

There is also a risk that PES can create perverse incentives for people to cause negative externalities in the hope that they can subsequently extract payment for refraining from doing so. Strict laws will be needed to discourage this kind of “greenmail” from happening, perhaps by clarifying the practices that are acceptable and not acceptable. Researchers at ICRAF use a traffic-signal analogy whereby a red light signifies land uses, such as dumping toxic waste, that are strictly prohibited; a yellow light signifies those that are to be discouraged by fines and restrictions even if they are not strictly outlawed; and a green light signifies perfectly legitimate land uses such that, if others wish them to stop these land uses, they would have to pay for the privilege.

PES systems depend on location-specific conditions that can best be understood by local environmental service users and potential suppliers. This implies the need for laws that are flexible enough to allow local parties to develop their own solutions to environmental problems. The city of Heredia, Costa Rica, needed an exemption from Costa Rican laws to establish its innovative PES arrangement, which operates outside the national program.

## **Collective action**

Collective action is often an important feature in successful natural-resource management, particularly for high exclusion cost (common pool) resources that cannot easily be managed individually. Cases where collective action matters for PES follow.

Watershed services are subject to threshold effects. Protecting a watershed requires adoption of watershed protection practices on a critical mass of the watershed; isolated adoption would not provide the environmental service. In such a case, watershed inhabitants must act collectively, providing the environmental service as a group. Buyers of the watershed service would have to contract the group of watershed inhabitants as a whole. Watershed inhabitants would have to jointly police each other to

protect against free riding, and they would have to jointly divide up revenues from the environmental service payment.

Even for carbon sequestration, where the service is delivered on individual parcels of land, collective action may be needed to reduce the transaction costs associated with establishing contracts, monitoring compliance, and making payments to individual providers. For example, large carbon buyers around the world cannot efficiently contract with small farmers unless they band together as a group to control transaction costs. Intermediary organizations can facilitate the relationship between the large buyer and the group of farmers. If environmental service providers operate as a group, they will also have greater bargaining power than if they act in isolation, and this can help ensure pro-poor arrangements.

## Further reading

Brent Swallow, Ruth Meinzen-Dick, and Meine van Noordwijk. 2005. *Localizing Demand and Supply of Environmental Services: Interaction with Property Rights, Collective Action, and the Welfare of the Poor*. CAPRI Working Paper 42. Washington, D.C.: IFPRI. 2005.

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