

Climate finance: mobilising domestic budgets and external funds for adaptation

Introduction

The governments of 192 countries have submitted policy commitments on tackling climate change in their Nationally Determined Contributions under the Paris Agreement.¹ However, identifying funding to meet these commitments is extremely challenging. Further, for highly vulnerable countries, the cost of dealing with the impacts of climate change, such as extreme weather events, threatens fiscal sustainability. While annual adaptation costs for low- and middle-income countries are estimated to range from US\$ 140 billion to US\$ 300 billion a year by 2030², actual financial flows (domestic and international) for adaptation had only reached about US\$ 46 billion in 2019/20.³

Key messages

- » The impact of climate risks on public finances should be explicitly identified and incorporated into strategic planning to achieve better medium- and long-term public financial stability.
- » Integrating climate change into national public financial management (PFM) processes, using tools such as climate change financing frameworks and budget tagging, can play an important role in addressing the climate adaptation financing gap.
- » Factoring climate risks into national PFM processes can ensure that domestic budgets are well spent, by:
 - identifying public finances that deliver positive climate change benefits, thereby supporting the case for their continuation or expansion;

International climate funds can appear to be an attractive solution for closing this funding gap; however, they represent limited sources of finance and their processes can be slow and laborious. Even after the developed nations achieve the US\$ 100 billion annual target set for mobilising international climate finance towards the developing world, the majority of the current adaptation financing gap will need to be met by domestic public finance, given the volume of investments required.

An important (but often overlooked) tool for identifying and delivering adaptation funding is integrating climate

- identifying where climate risks need to be taken into account, thereby highlighting the need for expenditures or investments to be re-designed to withstand future risks; and
- identifying expenditures or investments in activities that increase vulnerability to these risks, thereby highlighting the need for their reduction.
- » Climate-integrated PFM processes can also reduce the financing gap by leveraging international funding, by strengthening evidence that shows domestic finance gaps, and by showing how domestic spend can be used for project co-financing.
- Institutionalising this approach, rather than undertaking a one-off exercise, will provide a basis for future climate-smart decision-making and accountability, as well as for mobilising finance.

change into national PFM processes. The PFM cycle (see Box 1) supports the setting of medium-term strategic goals, allocations and expenditures, as well as ensures accountability and transparency. When integrated with climate change responses, PFM tools help countries identify and report domestic resources that already address climate risks. Countries can then spend *better*, by reallocating funds to achieve greater climate benefits. And they can spend *wiser*, by modifying public investments so as to be better prepared for future climate risks and by steering public resources away from actions that worsen vulnerability to climate risks. They can

¹See https://unfccc.int/process-and-meetings/the-paris-agreement/nationally-determined-contributions-ndcs/nationally-determined-contributions-ndcs

² See UNEP's Adaptation Gap Report 2020

also pave the way for mobilising additional funds from external sources.

Factoring climate risks into national PFM processes is an important step in meeting the critical challenge of

adaptation financing. This paper shares insights into our work in multiple countries and regions on how the benefits of institutionalising climate change into PFM can be achieved.

Box 1: The PFM cycle

PFM refers to the systems within a country that are established to support the sound management of the country's public finances, and, more broadly, the implementation of its fiscal policies. This includes the objectives of sustainability, effective budget allocations, and efficient implementation of public programmes (IMF, 2013). PFM follows an annual cycle, which provides various points of entry and suitable instruments for integrating key thematic concerns, such as climate change. The PFM cycle includes the following stages:

- 1. Strategic planning and budget preparation (macroeconomic forecasting, medium-term and annual budgeting processes, issuing guidelines such as budget circulars).
- 2. Budget approval (budget hearings, defence of submitted budgets, parliamentary scrutiny of budget submissions).
- 3. Budget execution and monitoring (procurement, cash management, expenditure tagging and tracking, reporting against performance indicators, budget revision/supplementary budgets).
- 4. Accountability and scrutiny (audit, evaluation, and scrutiny by parliamentary as well as non-government stakeholders).

Identifying and quantifying climate-related fiscal risks

Governments bear a major part of the costs of climate impacts, both acute and chronic. These impacts also negatively affect government revenue and expenditure (such as the costs of recovery and reconstruction, and additional social protection costs after floods and droughts). It is important to recognise this explicitly and to estimate the costs that will be absorbed by national budgets and government balance sheets (see Box 2). This is best done by factoring climate risks into medium-term budgets, fiscal statements, and macroeconomic policies. Tools exist to help governments do this, such as climate change financing frameworks⁴ (CCFFs), which can be applied to enable the integration of climate change risks into medium-term budgeting as well as annual sectoral budget preparation processes.

By ensuring that climate change concerns are accounted for in its strategic planning, a government can improve its long-term decision-making, as well as providing reasonable predictability in sectoral allocations. This, in turn, supports ministries to undertake large-scale adaptation interventions. This is also key to enabling the institutionalisation of measures like budget tagging and scrutiny from a climate change perspective.

Box 2: Ethiopia's macroeconomic and fiscal framework for capturing fiscal risks from climate emergencies

Through the Building Resilience in Ethiopia (BRE) programme, Oxford Policy Management (OPM) is supporting the Fiscal Policy Directorate within the Ethiopian Ministry of Finance to identify, quantify, and manage climate and humanitarian risks. This includes estimating the potential costs of shocks to government. This information can then inform allocation decisions and sectoral planning, in order to strengthen preparedness for future shocks. These quantifications will be incorporated into the country's annual Fiscal Risk Statement and Fiscal Risk Registry, and relevant government stakeholders will also be trained on how to assess and manage these fiscal risks.

Systematic identification of climate change relevance in public budgets

'Climate-relevant' finance is domestic expenditure that aligns with national climate change objectives, as laid out in national policies and climate action plans. Various approaches have been developed to identify and quantify the climate relevance of public budgets (see Box 3). This requires a careful review of all government expenditure, to identify its importance to climate change mitigation or adaptation. This is often referred to as budget tagging.

To achieve the full benefits of incorporating climate aspects into PFM, reviews of climate change relevance in public budgets should not be a one-off exercise, providing a snapshot at a single point in time, but should be the basis for institutionalising stronger budgeting practices that can inform reporting and decision-making on the

⁴ For more information on this, refer to OPM's work in South Asia under the Action on Climate Today (ACT) programme (Allan et al., 2016). CCFF approaches have also been adopted in the Asia Pacific region by the United Nations Development Programme.

Box 3: Approaches to tagging budgets on climate change

There are various approaches to budget tagging, which broadly fall into two types, differing in terms of whether they study a programme's *objectives* or the expected climate change *benefits* that would arise from the programme.

Objectives-based methods analyse programmes based on whether a direct/indirect climate change linkage is evident from the programme's objective. Examples of objectives-based methods include the OECD Development Assistance Committee's Rio Markers for adaptation and mitigation, the Joint Multilateral Development Bank (MDB) Finance Approach to track climate finance, and Climate Public Expenditure and Institutional Reviews.

Benefits-based methods include climate change impact appraisals (CCIAs), which study the relative benefits of a programme from a climate change perspective, in comparison to the programme's regular development benefits. Hence, if a programme is more valuable in a climate change scenario, it is due to the additional climate change benefits accruing from it: this differential, taken as a proportion of total programme benefits, determines the degree of climate relevance of the programme itself. CCIAs help understand both (a) the *climate change relevance* (i.e. the potential contribution of a programme to addressing climate risks) and then (b) the *climate change sensitivity* (i.e. the impact that could be suffered by the programme due to these risks, in the absence of climate-proofing – in the form of measures to adequately safeguard against future climate risks).

As well as identifying programmes that contribute to adaptation and mitigation (and cross-cutting elements of disaster risk management), it is also important to analyse their degree of relevance to climate change. For example, while two programmes may both have the potential to reduce vulnerability to climate change impacts, a programme that is designed *exclusively* for promoting climate-resilient crop varieties (say, by promoting drought-resistant seeds), would be assessed as having more climate adaptation relevance than another programme that promotes water conservation *as part of* a larger programme (say, a watershed management initiative).

Sources: Allan et al. (2016), Climate Change Innovation Programme (2018a)

targeting of internal and external finances. A budget tagging system, when institutionalised, can identify key sectors and programmes that are important for climate change (refer Box 4). They can also identify opportunities for enhancing the 'benefits' to tackling climate change from these budgets, which should then feed back into improved sectoral planning and resource mobilisation.

Box 4: Climate change budget reviews in India

As part of the Action on Climate Today (ACT) programme, OPM has worked with the sub-national governments of Assam, Bihar, Chhattisgarh, Kerala, Odisha, and Maharashtra in India to identify climate-relevant programmes that can be further scaled up for funding, and those which need additional climate-proofing (based on the CCIA approach).

In Odisha, the government has adopted the benefits-based classification of its budgets and has incorporated this analysis into its sectoral planning. This has led to the mainstreaming of climate risk-informed planning and budget allocations. The government also reports climate relevance as part of its annual budget statement.

Similarly, in the state of Chhattisgarh, this climate change budget review supported the decision to create an additional budget of US\$ 5.7 million in 2019/20, of which about US\$ 770,000 has been allocated so far (Allan et al., 2019; Finance Department, Government of Chhattisgarh, 2020, 2021). This means that the government not only identifies programmes that are of a high priority for climate change but has also institutionalised a funding route to support climate-resilient water sector initiatives.

Sources: Climate Change Innovation Programme (2018a), (2018b)

Informing external resource mobilisation

Using PFM tools to strengthen domestic resource use can also help mobilise additional external resources. Climate change budget reviews can provide evidence highlighting shortfalls in finance for priority activities to address climate impacts, as well as quantifying domestic funding that is being spent and that can thus be used for co-financing. This can strengthen the case for additional finances from dedicated climate funds, such as the Green Climate Fund (GCF) and the Adaptation Fund.

Countries can also frame investment appraisal criteria along these lines, to promote a pipeline of green financing opportunities to potential domestic and international investors. For instance, we developed a prioritisation approach using the benefits-based budget review method, to help governments short-list proposals for their GCF project pipeline (refer Box 5). Climate change budget reviews can also help a country tap resources through green/climate resilience/sustainability bonds. For instance, green sukuks in Indonesia⁵ and Sovereign Green Bonds in Nigeria⁶ are examples of sovereign bonds with eligibility criteria that are inspired by those countries' earlier climate change budget reviews.

Box 5: Assessing external finance priorities

OPM, supported by the GCF Secretariat, has supported national designated authorities (NDAs) under the GCF in eight countries to strengthen their pipelines for external funding. As part of this initiative, OPM has helped the governments of Cambodia, the Maldives, and Myanmar to assess the potential impact (on climate and on wider development) of ongoing and proposed interventions. Based on the criteria used in a benefits-based budget review, OPM developed a prioritisation approach to score and short-list interventions, targeting the investment criteria that the GCF applies as part of its assessment of climate funding proposals. Using this approach, governments can also strengthen their case for co-financing from budget resources or national development finance institutions etc. Thus, climate budget reviews can directly inform and support the case for GCF funding.

In conclusion, PFM systems provide a framework that binds national (and sub-national) institutions together in the mandate of delivering public goods and services in a country, and climate responses undoubtedly fall within this ambit. This critical linkage between PFM and promoting climate actions has also been duly recognised by the Coalition of Finance Ministers for Climate Action, as part of the Helsinki Principles, endorsed in 2019. Countries should recognise the multiple gains that can be obtained by ensuring climate risks are reflected in their budgets, including more efficient use of limited domestic funds, as well as informing co-financing opportunities.



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