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**Research Report**

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## Financing Adaptation to Climate Change through Budget Support

Adaptation to climate change is an inevitable challenge, especially in developing countries. Recent calculations show that costs of adaptation and corresponding needs for financial support are high. The international community therefore has to face urgent questions on how to meet these financial needs on the one hand and how to channel available funds to respective developing countries and vulnerable communities on the other. In bi- and multilateral development cooperation, there is a strong trend towards programme-based approaches and general budget support for financing multi-sectoral poverty reduction strategies. These instruments can also

be relevant for funding adaptation measures as a means of supporting a country-driven integration of adaptation into national policies. In order to use general budget support or programme-based approaches for adaptation funding, however, the following issues need to be addressed: (i) ensure a country-driven integration of adaptation policies into poverty reduction strategies and development planning, (ii) take a participatory approach to the policy dialogue and (iii) develop an assessment framework for monitoring and evaluation. The establishment of an independent expert panel could support the implementation of these tasks.

### Relevance of adaptation to climate change

The Fourth Assessment Report of the Intergovernmental Panel on Climate Change (IPCC) has shown that climate change seriously threatens poverty reduction and economic growth in developing countries. According to the IPCC, there is a high level of agreement and much evidence indicating that with current climate change mitigation policies and related development practices global greenhouse gas (GHG) emissions will continue to rise over the next few decades. GHG emissions at or above current rates would cause further warming and induce significant changes in the global climate system during the 21st century. The projected average surface warming at the end of the 21st century could reach up to 6.4° C relative to the last two decades of the 20th century.

Alongside to a drastic reduction of GHG emissions, adaptation to the impacts of climate change is therefore an inevitable challenge, especially in developing countries that are highly vulnerable to the effects of climate change. Recent estimates have shown that costs of adaptation and corresponding financial needs are high. The international community, therefore, has to face urgent questions on how to meet these financial needs and how to channel available funds to respective developing countries and vulnerable communities.

Experience with current funding mechanisms for adaptation under the United Nations Framework Convention (UNFCCC) has shown that they are still inadequate. Adaptation is underfunded and the reform of lengthy bureaucratic procedures for accessing funds under the Global Environmental Facility (GEF) has still to prove its

practicability. Bi- and multilateral development cooperation therefore still play an important role in supporting adaptation action in developing countries. Moreover, Official Development Assistance (ODA) is an important additional source of government resources in many countries.

In the past years, international development cooperation has seen a strong trend towards programme-based approaches, basket funding and sector and general budget support. The main reason has been to reduce transaction costs and to integrate donor support into country-driven national development policies.

Similarly, support of adaptation action requires an efficient use of funds as well as an integration into country-driven development policy and planning. There is an urgent need to go beyond vulnerability assessments and the implementation of singular, stand-alone adaptation projects typical of current practice in international adaptation finance. This paper analyses whether budget support, as a specific form of programme-based approaches already well-established in development cooperation, could be a viable approach for adaptation funding as well.

### The need to channel large sums

Global funding requirements for adaptation to climate change in developing countries are high. The UNFCCC estimates that the additional investment and financial flows needed will amount to several tens, and possibly hundreds, of billions of USD annually in 2030. Calculations are based on scenarios in five sectors. For water supply infrastructure, for example, the additional in-

vestment needed in 2030 is estimated at USD 11 billion, 85 % in developing countries. In an analysis of the climate sensitivity of its portfolio, the World Bank assumes that an additional 5 to 20 % in ODA will be needed to reflect the challenges posed by climate change. It has thus estimated that development costs will increase by USD 10 billion to USD 40 billion per year. Calculations of costs of adaptation projects proposed in National Action Plans of Adaptation (NAPA) under the UNFCCC amount to total costs of more than USD 800 million. This calculation is based on 38 NAPAs and 385 projects which consider only urgent and priority adaptation activities in least developed countries. The results can therefore not be considered as representative but must – like other cost estimates of adaptation – be seen rather as a rough indication of the order of magnitude of additional costs and financial needs.

To raise these funds, different funding sources are being discussed as possible options at the international level. One option is a levy on trading with different emission rights. Such a levy could generate USD 10 to 50 million between 2008 and 2012. The introduction of auctionable use rights for international air and maritime freight could generate USD 10 to 25 billion. A further USD 10 to 15 billion could be generated through a levy on international air tickets.

Calculations of new funding sources for adaptation action as well as the cost estimates above show that potentially available funding can and needs to reach substantial amounts. The need to transfer large amounts of money cannot be met through a project-by-project-based approach alone, which is currently still common practice in international adaptation funding. As an alternative option, programme-based approaches such as budget support are therefore being considered, also under the Adaptation Fund of the Kyoto Protocol, which is being set-up and is expected to start operating in 2009.

Alongside possible new funding sources, traditional bi- and multilateral ODA is used to facilitate adaptation action. At present, there is no clear data available on how much ODA from bi- and multilateral sources beyond the GEF has already been spent on adaptation measures. The OECD Development Assistance Committee is currently developing guidelines for the integration of adaptation to climate change into ODA statistics, and on the basis of these it will be possible to specify the share of ODA being spent for adaptation measures.

The difficulty involved in distinguishing ODA and adaptation expenditures is largely due to the considerable overlap between poverty reduction measures and measures to reduce vulnerability to the impacts of climate change. This is especially the case for measures addressing the drivers of vulnerability to climate change and for capacity development, while stand-alone proj-

ects and efforts to deal with climate risks can be distinguished more easily. The considerable overlap in the two areas, however, highlights the need for an integrated approach towards adaptation in development cooperation and practice. It also demonstrates that ODA remains an important funding source for adaptation action. The question is to what extent and under what conditions ODA funds for adaptation measures will be politically accepted as contributions to adaptation action under the UNFCCC? What are respective criteria for adaptation funding under the UNFCCC and what criteria and experiences with budget support and programme-based approaches in development cooperation?

### Criteria for financing adaptation

In the Bali Action Plan of 2007, developed country parties committed to provide “improved access to adequate, predictable and sustainable financial resources and the provision of new and additional resources” to developing countries. Under the climate convention, developed countries committed to “assist the developing country parties that are particularly vulnerable to the adverse effects of climate change in meeting costs of adaptation to those adverse effects” (Article 4.4).

The UNFCCC does not mandate the pursuit of any particular adaptation policy by a party. Instead, the interpretation of what is meant by adaptation is left to each country, as is the task of determining appropriate and adequate adaptation measures. The criteria of sovereignty and country-drivenness in the identification and implementation of adaptation activities will also apply to financing under the Adaptation Fund.

Another central funding criterion in the UNFCCC is cost effectiveness to ensure global benefits at the lowest possible costs. The UNFCCC highlights the catalytic and synergetic role of the convention and its financial mechanisms. It encourages multilateral bodies, the public and private sectors and civil society to build on synergies among activities and processes, as a means to support adaptation in a coherent and integrated manner. The need to implement adaptation in a cost-effective and synergetic way is highlighted by the order of magnitude of the adaptation costs to be expected.

The idea of an integrated approach to adaptation and the concept of mainstreaming pursued in development cooperation is criticised by some parties in international climate change negotiations because of its potential to divert aid. At present, funds provided for adaptation through the financial mechanisms under the convention are counted as ODA without any need to prove the additionality of the funds.

### Is budget support a viable option?

The criteria established by the UNFCCC are closely related to the principles of the Paris Declaration on Aid

Effectiveness (see box 1) from March 2005, which were recently reaffirmed at the Third High Level Forum in Accra in September 2008.

**Box 1: Principles of the Paris Declaration on Aid Effectiveness**

1. **Ownership:** Partner countries exercise effective leadership over their development policies and strategies and co-ordinate development actions.
2. **Alignment:** Donors base their overall support on partner countries' national development strategies, institutions and procedures.
3. **Harmonisation:** Donors' actions are harmonised, transparent and collectively effective.
4. **Managing for Results:** Managing resources and improving decision-making for results.
5. **Mutual Accountability:** Donors and partners are accountable for development results.

Source: High Level Forum (2005)

There has been an intense debate in the international development community on how best to implement these principles for more effective aid. Over the last years this has evolved into a widely shared – but by no means undisputed – conviction that so-called programme-based approaches (PBAs), and in particular general or sector budget support, are currently the most promising avenues to improve the effectiveness of international development aid.

The main feature of PBAs is the use of developing countries' own systems for the management of aid resources, in particular with regard to planning, budgeting, financial management, monitoring and evaluation. The intention of channelling aid through developing countries' own administrative systems is to reduce transaction costs, avoid parallel administration processes, and to strengthen national institutions and overall governance.

PBAs can take different forms, ranging from individual contributions to recipients' programmes and policies over the pooling of various donors' support for more or less confined reform and work programmes (basket financing), to arrangements that involve direct financial support to a whole sector or even the national budget. Sector and general budget support (GBS) are intended to support recipient countries' sector policies and national development and poverty reduction strategies (PRS). The main difference between the two approaches (besides the former being paid into an individual ministry's account and the latter into the general government account) is the focus of the accompanying policy dialogue between donors and recipients and the conditions attached to the support. In the case of general budget support, this dialogue tends to cover the ensemble of government policies and explicitly takes into account issues that cut across sectors that are difficult to address with other aid modalities.

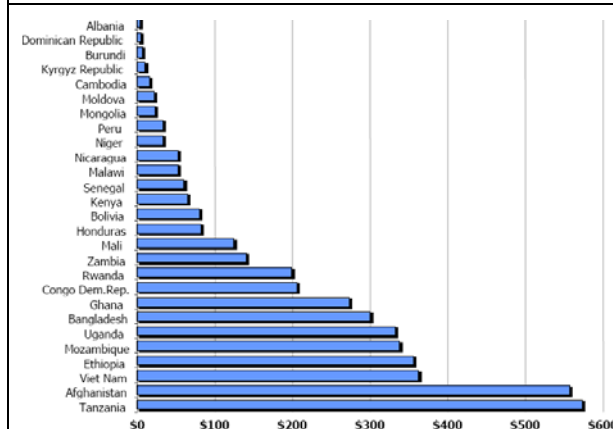
PBAs, and in particular sector and general budget support, have now become well-established instruments

for Western donors to support national poverty reduction strategies, in particular in many Sub-Saharan African LDCs. However, individual donor approaches to the use of the instrument in terms of design and country selectivity tend to differ substantially. This is partly due to different emphasis placed on objectives of the instrument (e.g. as a tool to foster good governance versus the financing function of budget support) as well as differences in the way fiduciary risks (i.e. the risk that funds may be used inefficiently or for purposes other than those intended) are perceived and managed.

Yet, despite these differences, there are common features to most budget support operations that in a way characterise the 'standard model' of GBS in LDCs. In virtually all cases where multiple donors provide GBS, they form dedicated budget support groups to coordinate the content of the policy dialogue with the recipient government, donors' assessment of government performance, and (albeit not always to a satisfactory degree) the conditions for disbursement of individual donor contributions. Normally, one or more donors (on a rotating basis) take the lead to facilitate these processes. Government performance is regularly measured against a previously negotiated Performance Assessment Framework (PAF), based on indicators derived from the national PRS or similar national development frameworks.

Donors are asked to make predictable commitments (increasingly on a multi-year basis) and disburse aid in line with national budget cycles in order to provide predictable and continuous funding for national poverty strategies.

**Box 2: Direct Budget Support to Developing Countries in 2004**



Source: Manning (2006)

In the past, the policy dialogue focused strongly on social sectors. But with so-called 'second generation' PRS in place in many countries, it is increasingly shifting towards other policy areas, in particular to productive activities and policies for economic growth. Policy dialogue thus increasingly addresses cross-cutting issues

that could be of relevance for adaptation to climate change as well.

Given the common features of the funding criteria formulated in the UNFCCC on adaptation and the aid effectiveness debate, and looking at the tremendous financing needs identified, it is a straightforward question whether budget support would be an adequate instrument for adaptation funding. In principle, it is easily conceivable to extend financing and policy dialogue arrangements of general or sector budget support to adaptation policies and programmes.

There are, however, caveats and open questions concerning the use of budget support as established in development cooperation for adaptation financing with regard to the UNFCCC. Three issues are especially challenging: political and disbursement conditions, governance aspects related to the policy dialogue and the development of an assessment framework.

Budget support in development cooperation is currently tied to an intensive policy dialogue and to disbursement conditions. This practice clashes with the understanding of developing country parties under the UNFCCC, which do not consider adaptation funds as "donations". Hence there are political reservations with regard to traditional terms of ODA and conditionality. For this reason, the GEF has continuously been criticised as a funding mechanism of the UNFCCC for a governance structure that favours donor countries. In this regard, the Adaptation Fund being set up under the Kyoto Protocol marks a fundamental change in the international aid architecture, with developing countries now in the majority on the fund's board. How could this be reflected in PBA approaches in ODA? How can the country-drivenness of the dialogue be strengthened or ensured?

The question concerning how to ensure the country-drivenness of adaptation policies closely relates to another aspect of national governance which is of importance in adaptation finance. It is difficult, on the basis of scientific information alone, to make a judgement on what are "good" or "right" adaptation measures and policies. Part of the decision always remains political. Therefore, the question of who, from the recipient country, participates in the policy dialogue is crucial as well. The decision on adaptation policies needs to be socially embedded. This calls for a participatory approach to the development of policies and the assessment framework. A representative, independent expert panel could support both processes.

The development of an assessment framework that contains indicators related to the monitoring and evaluation of policies and measures related to adaptation to climate change is one of the main challenges. Even though funds for adaptation might not be considered as donations, the development of monitoring and

evaluation indicators for adaptation measures is also an important issue to be addressed under the UNFCCC regime and the Adaptation Fund. Mechanisms will have to be established that ensure the efficient and effective implementation of adaptation activities. The development of dedicated monitoring tools and performance indicators for adaptation to climate change, however, is still in its infancy and there is little practical experience to fall back on.

## Conclusions

Budget support could be a viable instrument to channel funds for adaptation to recipient countries in ways that are line with the criteria established by the UNFCCC for financing adaptation. Among the points in favour of this instrument are: (i) it aims at reducing transaction costs and at an efficient use of funding through coordination, (ii) it offers the possibility of an integrated approach with development planning, (iii) it has an existing assessment framework on which adaptation finance could build and (iv) it offers the possibility to channel large amounts of funding.

Yet, a number of challenges will need to be addressed to adjust programme-based approaches and in particular budget support to international adaptation funding criteria. Adaptation funding through budget support will require the development of an adaptation-specific assessment framework. This is scientifically challenging and there is little practical experience to fall back on. It needs to be ensured that the integration of adaptation policy into development planning and poverty reduction strategies is country-driven and that policy decisions on adaptation are embedded in national contexts. Furthermore, coordination among donors that takes place for the implementation of budget support should be expanded and also give due consideration to possible synergies with the UNFCCC regime and the Adaptation Fund.



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