IRF2015

BACKGROUND PAPER 2

Financing for Sustainable Development:

Country systems and other issues and options for enhancing the coherence and effectiveness of development and climate finance

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IRF2015 is a collaboration of 11 leading research institutes from across the globe that responds to the need for independent, rigorous and timely analysis to inform the evolution of the post-2015 development agenda and the concurrent intergovernmental process on Sustainable Development Goals (SDGs) agreed to at Rio+20. IRF2015 partners envision a post-2015 development agenda that is universal in scope, takes an integrated approach to the economic, social and environmental dimensions of global development challenges, and can lead to more sustainable and equitable development outcomes for all.

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Summary

This paper examines the question of how practically we might achieve greater alignment between the use of development and climate finance, and sets out steps towards an integrated sustainable development financing framework. It thus links closely to discussions around creating synergies between the agendas of the Monterrey and Rio processes, and many of the issues discussed are in fact relevant for other flows of international finance, including those under the Rio Conventions on Biodiversity and on Desertification as well as for disaster risk reduction and environmental themes such as sustainable land management. The paper focuses largely on international public finance, however the approach to integration and coherence applies equally to other sources of finance, including both domestic and international sources.

The paper first briefly describes the current development and climate finance delivery channels and some of the concerns about lack of effectiveness, including some of the political economy challenges that exist and need to be acknowledged. It then elaborates some principles which might be used to guide the design of an international sustainable development financing framework, incorporating finance for development and for climate change. It emphasizes the importance of allocating finance through country systems for national social and economic development planning and budgeting, and also a need among funders and developing countries to shift from sectoral planning and budgeting to more integrated, sustainable development planning and budgeting. Finally, the paper presents some of the opportunities for reform to achieve this integrated financing framework for sustainable development, particularly in 2015.

Introduction

Much international attention has justifiably been on the challenge of *mobilising* more financial resources for developing countries, but the question remains of *how effectively* these resources are used to support developing country national priorities, and how well they connect with—and support—country systems of planning and budgeting. There continues to be concern that neither international public development finance, nor more recently climate finance, is bringing about the type and scale of transformation expected and needed in economic and social development in developing countries. There are also concerns about its success in reaching the poorest and most vulnerable sections of society.[1]

Despite their different heritage, many of the broader goals of development finance and climate finance overlap and can be aligned. Each is primarily concerned with supporting developing countries in the fundamental goal of creating a secure, peaceful and prosperous future. Whether the goals are thought of as related to "sustainable development" or "building resilience", on the ground many of the activities that need to be supported for development are also those that will build resilience to climate change, which means the objectives of the different finance agendas are to a large degree coherent. **This creates opportunities for greater alignment in the delivery of finance, and for targeting use of funds at multiple objectives simultaneously**.

[1] See for example: Stadelmann, M., Å. Persson, I. Ratajczak-Juszko & A. Michaelowa, 2013. Equity and cost-effectiveness of multilateral adaptation finance: are they friends or foes?. In International Environmental Agreements: Politics, Law and *Economics*, DOI 10.1007/s10784-013-9206-5; Persson, A. & E. Remling (2014): Equity and efficiency in adaptation finance: initial experiences of the Adaptation Fund, *Climate Policy*, DOI: 10.1080/14693062.2013.879514

Features of international public development and climate finance and challenges for increasing effectiveness

A number of structural and governance problems are evident in the delivery of development and climate finance[2] which may limit their effectiveness. These include:

1. **Different international processes around development and climate finance use different terminology**, which can be confusing and suggest they are promoting different objectives. At the national level this has sometimes caused confusion and as implementation challenges mount the argument for greater alignment and convergence is now urgent. As an example from within the realm of climate change, countries are being encouraged to develop national adaptation plans (NAPs), nationally appropriate mitigation measures (NAMAs), REDD+ strategies, low carbon development strategies, green economy strategies and climate resilience strategies. These diverse expectations—often promoted by different institutions (or sometimes different parts of the same institution)—undermine attempts by countries to develop a *holistic* approach to achievement of a secure, prosperous future.

2. **Available climate finance tends to be directed towards national-level capacity building and infrastructure projects rather than household-level needs of the poorest and most vulnerable.** As a generalisation, neither the scale of finance nor the types of activities that climate finance is being used for connects very well with the livelihood challenges and expenditures that poor households face. For instance, international public climate finance comes in project-based chunks, which for ease is typically then spent on discrete, major projects (for example infrastructure) rather than on enabling small-scale, dispersed activities that may be much more important to the most vulnerable communities.

3. **The delivery of finance is highly fragmented** with many different actors involved. Within the spectrum of climate finance alone, there are more than ten dedicated multilateral climate funds, as well as significant volumes of multilateral and bilateral finance channeled through traditional ODA and the emergence of public private partnerships. Fragmentation means recipient countries are burdened with managing different donor protocols, administrative procedures and layers of other donor demands that divert their own limited domestic capacity towards "donor management" rather than dealing with resolving domestic challenges. This perverse effect is growing as donors are themselves under pressure from their domestic constituencies to have visibility and to demonstrate impact. There may also be the pursuit of specific strategic objectives by donors, such as commercial considerations to promote national exports, and this works against blending (reduced fragmentation) of international finance. Among international development banks and UN agencies there are vested interests in maintaining separate funding streams, related to their role as financial intermediaries, promotion of their institutional branding and identity and maintenance of their funding from donors.

4. **The financing of development goals and of climate objectives has become "projectised."** This phenomenon is growing as (with a few exceptions) donors move away from mechanisms such as

[2] Climate finance is usually described in terms of "mitigation" (focused on reducing GHG emissions) and "adaptation" (focused on improving the resilience of people and ecosystems to the unavoidable impacts of climate change). While both are expected to contribute to local/national benefits and thus be aligned with local/national priorities, for mitigation there is also an expectation among funders of maximising global benefit (i.e. GHG reductions). This difference influences who might reasonably expect to have a say over how finance is used, since for mitigation the decision over allocation and use of funds should reasonably involve both national actors (to align with national priorities) as well as international actors (to align with global expectations and needs).

direct budget and sector support and towards stand-alone projects, in response to concerns about accountability and corruption, value for money and impacts being measurable. The result is development or climate resilience and mitigation being packaged as small, incremental steps rather than supporting the systemic change needed to reduce vulnerability of people and ecosystems and to increase human security. As a hypothetical example, an adaptation project in agriculture may provide farmers in a region with support to manage climate-related yield reductions, whereas a more appropriate intervention may be structural transformation away from farming based livelihoods.

5. **The allocation of funds does not always reflect country-specific national priorities.** This is true of both bilateral and multilateral spending, including "vertical funds". Vertical funds are essentially vehicles for pooling global finance before channeling it to national and sector projects, and have been tried in areas such as the health sector, and also in the field of climate change. While in theory these could help to some degree in reducing fragmentation and have had some success in tackling specific issues and also in some cases improving sub-national participation processes, they have evoked other criticism including not responding sufficiently to national priorities. The use of standardized international criteria (or internationally-determined priorities) to allocate funding has the effect of diverting resources and attention away from more systemic and country-specific priorities. For example, global HIV funds concentrate resources in one area of health but do not pay sufficient attention to the broader health challenges a country may face, such as a lack of primary health care investments. Similarly, some climate adaptation funds limit the use of funding to a narrowly defined concept of adaptation rather than seeing adaptation as necessarily addressing the most strategic and holistic needs of recipients.

6. **Evaluations of effectiveness most often take the form of monitoring the delivery of short-term project outputs**, rather than an open and fundamental evaluation of what kind of lasting change, if any, is being produced (i.e. the quality of impact) and how sustainable the interventions become over time for recipients (i.e. the longevity of impact). This is partly a result of the "projectisation" described above.

7. **The emphasis on mobilizing private finance poses other challenges that need to be carefully managed.** The emphasis on private finance is a reflection of the fact that public funds are limited and alone will not be significant enough to address all development and climate-related goals. However, a focus on leveraging private finance also poses challenges, not least for those countries such as LDCs and SIDS which find it difficult to attract private investment and especially in non-resource sectors. Other issues relate to *governance* (how to ensure social objectives are met, not just private profit-making), *coherence* (how to shift the bulk of private investment towards "inclusive green economy" or sustainable energy objectives, as opposed to funding unsustainable development pathways and practices) and *ensuring donor support is not diverted away from such core public sector functions as planning and budgeting and public financial management* which are themselves needed for incentivizing effective private investment.

8. **The need for international public development and climate finance may often arise in exactly those countries that are conflict-prone with weak governance systems including limited public financial management.** This demonstrates that responding to development and climate finance challenges is bound up with addressing complex, governance challenges. Strengthening these governance systems and strengthening country systems will take time, but will lead to more lasting impacts than short-term project inputs.

To move forward and address some of these challenges, this paper examines the question of *how* to more effectively integrate international public development and climate finance under an integrated—and

practical—sustainable development financing framework using country systems of planning and budgeting.

Principles for the design of an integrated sustainable development financing framework

A number of broad narratives have emerged that imply changing the current international finance regimes, in particular at the point of delivery to recipient countries. These are reflected in various principles that have been articulated internationally for the purposes of guiding how we might encourage a more effective financing and development cooperation regime to emerge.[3] These are summarised in the box below.

Principles for design of an integrated sustainable development financing framework

- *Synergies between climate objectives and sustainable development objectives should be deliberately pursued*. It is essential to bring about greater alignment between development and climate finance in a way that makes achieving multiple goals in parallel a priority since, no matter how successful mobilisation efforts are, dedicated international public financial resources for development and for climate goals are, and will remain, limited.
- *Finance allocation should to the extent possible be aligned with national priorities and policies, thus improving national ownership.*[4] This means the international architecture for delivery of finance should be driven by national needs and capacities. Developing country governments, together with non-state actors, should define the development model that they want to implement, and cooperation should be tailored to their unique circumstances.
- *The delivery of finance should be designed around the needs of the poor and the vulnerable*. It should be structured around the perspectives and needs of the intended beneficiaries, connecting with poor households.
- *Transaction costs for recipients should be minimized.* Both fund fragmentation and donor demands (e.g. excessive reporting, donor meetings) should be minimised, so as not to place high demands on limited domestic capacities.
- *Effective institutions and good governance should be supported*. Within recipient countries these are prerequisites to building the trust and confidence needed among donors to encourage the mobilisation of more resources, and are essential to ensure overall policies and expenditures not only meet fiduciary standards, but are also designed to be pro-poor. Within donor countries better governance will help improve coordination and thus reduce burdens on recipients.
- *Finance should enable long-term processes of change and development*. The systemic changes needed to achieve sustainable development and climate resilience require long-term finance.

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[3] For instance, within the Busan Partnership for Effective Development Cooperation (2011) and the Report of the Intergovernmental Committee of Experts on Sustainable Development Financing (ICESDF, Final draft August 2014)

[4] There is an open question here about how well "national" ownership translates to, for instance, targeting the most vulnerable. National ownership adopts a government perspective, which does not always map well to the priorities of NGOs, businesses or particular citizens. Government objectives and priorities may not always include those of marginalized groups, for instance, and can in some instances even be to the detriment of some citizens. This is a limitation we need to recognize if "national ownership" is taken as the guiding principle, and hence why we suggest the additional principles focused on targeting the needs of the poor and vulnerable.

- *Impacts should be sustainable over time*. Interventions should produce change that is lasting, rather than short-term activity that is not maintained once projects finish.

- *Learning and evaluation should focus on the quality and longevity of outcomes and impacts*. Instead of the current focus on individual project outputs, learning and evaluation should be re-framed with respect to meaningful indicators of sustainable, positive (and negative) changes in households, ecosystems, governance structures and so on.

- *International public finance should facilitate partnerships between different kinds of actors and between different kinds of financial flows* (public and private, commercial and grant-based, etc.) in order to achieve more, but the formation of partnerships should not itself become an indicator of success (i.e. it is a tool rather than an end-product).

- *Financial support and other forms of cooperation should be transparent*. Cooperation for development and for climate change objectives must be transparent and accountable to all citizens, and this responsibility for accountability is shared between donors and beneficiaries.

Operationalizing the principles

The principles in the table above direct the kind of progress needed to establish a framework that will:

- improve national ownership;
- align development and climate outcomes through the process of the national development plan and budget;
- transform economies by placing sustainable development at the heart of key economic decision-making;
- combine international and domestic finance; and
- ensure that sustainable development is integrated across the public sector and incentive framework for the private sector, rather than delivered as stand-alone projects.

A common thread running through the principles is the notion of *integrating international public finance into a recipient country's own systems of planning and budgeting*. If national development plans and budgets have been prepared and properly consider climate change and the SDGs, then priorities emerging from these plans and budgets should be fundable, and there should be no need to require narrower criteria such as "climate risks" to be addressed by individual funding proposals, since these have already been taken care of in the national priority-setting process. The importance of country systems is highlighted by the long experience with ODA, yet donors in both the development and climate finance spaces are moving towards more project-based modalities. There are however some positive examples to draw on: the EU is using budget support for delivering some of its development aid (around 25% in 2011),[5] while the World Bank is starting budget-based climate support in Mozambique and elsewhere.

[5] According to https://ec.europa.eu/europeaid/node/13967

Country systems need to be supported by *effective Public Financial Management (PFM) systems*. A stronger PFM system—making budgets more transparent and accountable and reducing fiduciary risks—provides the basis for international public finance to move away from project-based support, towards the ideal of long-term programmatic support. PFM reform would involve support to Ministries of Finance, but also to the Supreme Audit institutions, parliamentary oversight bodies, civil society and the media to engage in a transparent and inclusive planning and budgeting process.

If national development plans and budgets have not considered climate change or integrated the SDGs, then international public development finance can provide systemic and institutional support for this. In such cases, funds to support countries in updating their national plans and budgets to incorporate climate change and SDGs will strengthen country systems of planning and budgeting. There is growing evidence of effective development agency support for mainstreaming climate and the SDGs in planning and budgeting processes from which to learn from.[6]

Learning and evaluations should be undertaken outside specific funds or projects, to enable longer-term and more critical analysis to emerge. As one model, a percentage of all international development/climate finance could go into an internationally and independently managed fund dedicated to providing public learning about interventions. Results should be measured against lasting impacts on addressing the SDGs, and this is bound up with the ongoing debate over a "data revolution" for the SDGs.

The political issue under the UNFCCC process of *separate accounting for ODA and climate finance* remains important. Separate accounting to ensure "additionality" can be preserved at the international level while at the same time national delivery of this finance is combined and managed through a single planning and budgeting process.

Opportunities for action in 2015 to advance an integrated finance framework for sustainable development

2015 is a year of genuine opportunity for addressing some of the issues discussed in this paper in order to achieve an integrated sustainable development financing framework, as key international agreements are negotiated around the SDGs and climate change.

As a first and critical step, developing countries need to *facilitate closer coordination between negotiators and capitals, and between Ministries of Environment, Ministries of Foreign Affairs/Development and Ministries of Finance*. Promoting the use of country systems of planning and budgeting will require effective coordination between international negotiators and their in-country colleagues in capitals, so that negotiators appreciate the importance of these country systems and how they work at country level. Within country there is a need for a more coherent dialogue between Ministries of Environment who typically lead on climate negotiations with Ministry of Finance and Ministry of Planning colleagues. The importance of the budget process and the Ministry of Finance in coordinating this process should be welcomed by Ministries of Environment who are needed to provide technical and scientific support to integrate climate change. Similarly, Ministries of Finance and Planning need to appreciate the importance of integrating climate and the SDGs into the national plans and budgets with the support of the line

[6] This includes work by the UN's Poverty Environment Initiative (PEI). See www.unpei.org

Ministries and civil society. This whole-of-government approach to climate financing has been facilitated by the undertaking of Climate Expenditure and Institutional Reviews (CPEIRs)[7] in a number of countries.

With improved coordination among these different practitioners, there are several tasks that need to be achieved during 2015 and beyond:

1. Ensure Post-2015 and UNFCCC processes agree on alignment of finance around country systems of planning and budgeting

This year many issues are being negotiated and will be agreed upon within both the post-2015 process and under the UNFCCC for both SDGs and climate change. Both processes will establish some concepts, principles and norms that are valuable for pushing wider change. It will be important to include principles relating to alignment and national ownership through the use of country systems of planning and budgeting within both the SDG and climate change arenas (including in discussions about the Green Climate Fund – see below) and fiduciary standards.

2. Ensure the Green Climate Fund delivers on its mandate of transformative finance through programmatic, sector and budget support with Ministries of Finance playing a leading role

This year the design of the Green Climate Fund (GCF) is also being further refined. The GCF is being established under the UNFCCC and has been envisaged as a primary channel for a large portion of future climate finance. It has a current capitalization of around $10 billion, though this figure is expected to grow significantly in future years. The GCF is of the scale and political importance that it might, if inclined to, act as a catalyst for major reform. If it follows the *status quo*, the fund may create separate windows and rely on diverse implementation channels to work with recipient countries, and thus not address fragmentation concerns. To date the GCF Board has also seemed inclined to go for a project pipeline approach and a pre-determined "optimum investment model", as in more traditional financing institutions.[8] Instead, a focus should be encouraged on ensuring the use of programmatic, sector and budget support to improve national ownership, coherence with domestic priorities and improve overall effectiveness. This requires ministries of finance take a stronger role in engaging with the GCF. So far only around half of developing countries have appointed a ministry of finance/planning or other senior ministry as their GCF National Designated Authority (NDA), with the rest nominating comparatively weaker ministries of environment. Both the GCF and applicant countries should be more specific on the need for ministries of finance/planning to take on the NDA role, since this will strengthen national-level coherence and national ownership around the budget process.

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[7] CPIERs "involve the analysis of allocation and management of public expenditures and may cover all government expenditure or focus on a few priority sectors such as agriculture, water, infrastructure, etc. Information gathered (from CPIERs) is used to provide key guidance to strategic planning and budget preparation and to identify ways in which to improve the efficiency and effectiveness of resource allocations" (source: http://www.aideffectiveness.org/CPEIR). Since 2011, CPEIRs have been conducted in many countries in Asia-Pacific with UNDP support, including Bangladesh, Cambodia, Indonesia, Nepal, Philippines, Samoa, Thailand, and Viet Nam. Building from the CPEIR approach, similar assessments of the national arrangements for managing and using climate finance have been undertaken for a number of Pacific countries, including Republic of the Marshall Islands and Tonga (currently underway).

[8] See for example Decision B.07/06 in http://gcfund.net/fileadmin/00_customer/documents/MOB201406-7th/GCF_B07_Decisions_Seventh_Meeting_fin_20140619.pdf

3. Developing countries can take a lead domestically and showcase this internationally

Developing countries themselves can also take steps to ensure international finance connects better with national priorities and national systems—with support from development partners where appropriate. Ministries of Finance in Kenya, Samoa, India and Indonesia for example have taken a pro-active approach by establishing climate finance teams to coordinate access and use of resources. A number of Pacific countries have negotiated with the European Union for climate finance to be delivered through sector and budget support. Mozambique's Ministry of Finance has taken the lead with a climate budget support process supported by the World Bank. The government of Kenya with DFID support has begun delivering climate finance through local government channels and is now upscaling this model to channel their own national climate-related funding. Showcasing these and other efforts internationally can provide examples to the negotiating processes of the innovation and progress happening at the country level in terms of increasing the integration of finance into country systems of planning and budgeting.

Equally important is that national and sectoral planning and budgeting shifts towards more holistic sustainable development planning and budgeting—as long as sustainable development and climate-related outcomes are considered separately rather than integrated holistically into planning, synergies between goals will be difficult to achieve and the outcomes will be much less effective. Without a shift to more integrated sustainable development planning and budgeting, the approach of relying on country systems may not deliver desired results.

4. Third International Conference on Financing for Development (FfD) to commit to use and strengthen country systems of planning and budgeting and to align development and climate finance

Agreement could be pursued at the FfD conference on the importance of harmonizing procedures and developing a common monitoring and evaluation framework for all major international public financing for sustainable development, based around the SDGs to be agreed this September. The SDGs could be used as the successors to the current Rio markers, and finance flows tracked against relevant SDGs not just at the international level but also at the national level.

In this FfD conference and the post-2015 agenda summit outcome, countries could commit to the participatory development of country systems for planning and budgeting that focus on progress towards the SDGs. International public finance for sustainable development could be allocated in accordance with an assessment of individual country needs in order to attain the SDGs (along with a binding timetable to meet current ODA commitments and an increase in the share to be allocated to LDCs). Consideration could be given to incentivising interventions that seek to contribute to multiple SDGs and that have been shown to produce greatest impact towards the SDGs. International public finance could commit to the use and strengthening of country systems for the alignment and delivery of finance so that SDGs and climate are integrated into existing plans and budgets. This should be the preferred option rather than separate stand-alone sustainable development or climate strategies or separate SDG finance strategies – as past experience has shown these separate attempts have failed.

In terms of how countries respond institutionally to the SDGs, it is important that the FfD process does not give impetus to the creation of national sustainable development strategies or SDG financing strategies that are separate from existing national development planning and budgeting. To ensure effective use of funds, and to direct funding towards the achievement of multiple objectives simultaneously, it is essential the SDGs, including climate change objectives, be woven into existing country planning.