Policy Brief | 2021

The integration of climate change into budgeting and finance

Acronyms and abbreviations

ARC	African Risk Capacity
CABRI	Collaborative Africa Budget Reform Initiative
CSO	civil society organisation
GDP	gross domestic product
GHG	greenhouse gas
IBFCCA	Inclusive Budgeting and Financing for Climate Change in Africa
IBP	International Budget Partnership
IIED	International Institute for Environment and Development
IPCC	Intergovernmental Panel on Climate Change
NDC	Nationally Determined Contributions
OECD	Organisation for Economic Co-operation and Development
PEFA	Public Expenditure and Financial Accountability
PFM	public financial management
SIDA	Swedish International Development Cooperation Agency
UNDP	United Nations Development Programme
UNFCCC	United Nations Framework Convention on Climate Change

1. Introduction

Climate change, which has long been considered an environmental and development issue for Africa, is now widely acknowledged as a pressing fiscal concern as well. The growing frequency and severity of climate-induced disasters, such as droughts, floods and cyclones, as well as longer-term trends in temperatures and rainfall variability, are depressing public revenues and putting more expenditure demands on budgets. Moreover, climate change is projected to cause an average annual loss of more than 3% of gross domestic product (GDP) for Africa between 2015 and 2050, with some countries forecasting even higher average losses.[1] Furthermore, climate change impacts men and women differently, with women on the whole more vulnerable because of their marginalised rights, resources and position in society.[2]

Governments in Africa are aware of the fiscal threat caused by climate change, and are already committing considerable public resources to tackling it. Recent reports have estimated that African countries are spending between 2% and 9% of GDP on environmental degradation and climate-related issues, with the Horn of Africa particularly affected following large-scale displacement brought on by climatic events.[3] There is a compelling value-for-money case for this expenditure; modelling from the World Bank has shown that preventative spending on adaptation leads to higher GDP growth rates than either taking no action, or waiting until remedial action is necessary, as it lowers the rate at which capital stock depreciates in the face of climate change, in turn leading to a higher longer-term growth trajectory.[4] At the same time, substantial economic gains are to be had spending on mitigation in pursuit of green growth trajectories.[5]

1 UNDP, 2018. Based on mid-range IPCC scenarios which involve an increase in temperature of roughly 2oC and a doubling of the frequency of rainfall variability, including floods, droughts, storms and other extreme events.

2 UNDP, 2012

3 ACPC, 2020

4 Forni et al., 2019

5 Global Commission on the Economy and Climate, 2018

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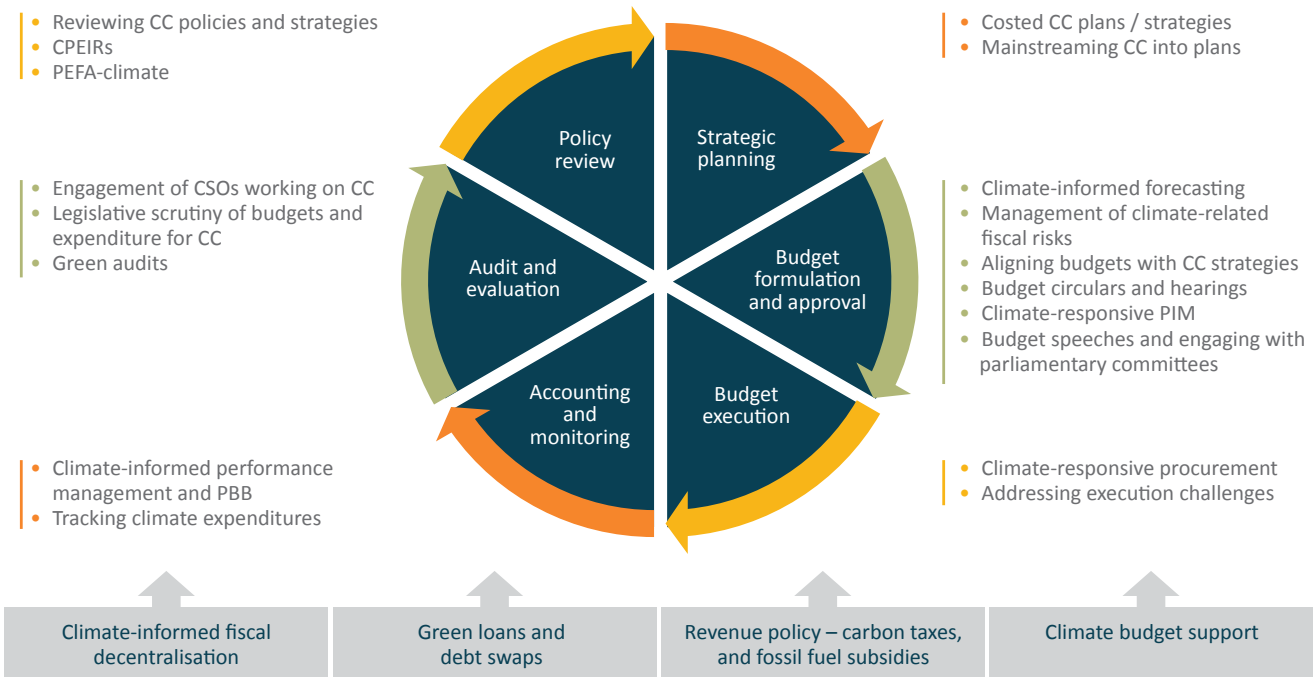
However, much more needs to be done to mobilise more domestic and international climate finance for Africa. If temperatures increase by 2°C – the Intergovernmental Panel on Climate Change's (IPCC) mid-range scenario – then current levels of adaptation spending (from public and private sources) are only enough to offset 20% of the potential economic impact from climate change on the continent.[6] With this imperative in mind, the Inclusive Budgeting and Financing for Climate Change in Africa programme (IBFCCA) is working to build climate-resilient societies in Africa through instituting pro-poor gender-responsive public climate finance systems. Funded by the Swedish International Development Cooperation Agency (SIDA), the four implementing partners (CABRI, the United Nations Development Programme (UNDP), the International Institute for Environment and Development (IIED) and the International Budget Partnership (IBP)) are providing support for the mobilisation of the wider national and local budgetary process involving government, legislatures, development partners and civil society. In the first Peer-Learning and Exchange, CABRI brought together 45 officials from 17 countries in Africa[7] to share experiences on how to integrate climate change into public financial management (PFM) systems. This Policy Brief summarises some of the key takeaways from the two days of rich presentations and discussions. All the peer learning materials used at the event, including publications and PowerPoint slides, are available from the CABRI website.

2. Tools and approaches

Addressing climate change through budgets requires us to adopt mainstreaming tools and approaches, as a wide cross-section of government spending is potentially vulnerable to the impacts of climate change and/or is potentially contributing to greenhouse gas (GHG) emissions. For this reason, mitigation and adaptation are best achieved by integrating climate change into regular public expenditure programmes, rather than establishing climate change as a standalone subsector or programme. In this respect, climate-responsive budgeting builds directly on the experience of other mainstreaming efforts, such as gender-responsive or pro-poor budgeting, which need to be fully overlaid as part of the integration of climate change in budgets for it to be impactful and just. Potential entry points span all stages of the budget cycle, as illustrated in Figure 1. For each of these entry points, there are more and less complex design options to serve a variety of objectives, from improving awareness raising to improving effectiveness of expenditure, or mobilising additional funding from internal and external sources.

Figure 1: Entry points for integrating climate change into the budget cycle



6 UNDP, 2018

7 The countries which participated include Benin, Cape Verde, Cote d'Ivoire, Ethiopia, Gambia, Ghana, Guinea, Guinea-Bissau, Kenya, Lesotho, Malawi, Mali, Mozambique, Nigeria, Rwanda, Seychelles and South Africa. Samoa also participated and shared their experience with piloting PEFA Climate.

3. A perspective from African countries

The exchange highlighted that the most widespread areas of climate-responsive PFM relate to upstream budget processes, in particular strategic planning and budget tagging/tracking. The opening session provided a snapshot of uptake of key reforms across Africa[8] which suggested that in total 40 African governments have produced a policy, strategy or plan regarding their climate change response, while a further five have integrated climate change in national development strategies. Furthermore, 53 countries have submitted some form of financial commitment for climate expenditure to the United Nations Framework Convention on Climate Change (UNFCCC), through their (Intended) Nationally Determined Contributions (I/NDCs). These plans and political commitments have proven to be a useful trigger for integrating climate change into PFM reforms; for example, many African governments are in the process of revising their NDCs, which requires a costing exercise and developing financing and investment strategies, where the engagement of the Ministry of Finance is paramount. In Rwanda, future plans to develop a climate budget tracking system were directly related to the need to monitor NDC implementation, and build on the Government's experience of gender budgeting, while the Government of Nigeria explained how its Sovereign Green Bond was an innovative means of meeting domestic financial commitments set out in its NDC. Moreover, the ongoing NDC revision process in many countries has highlighted the need for a comprehensive national climate finance architecture in order to fulfil commitments under the Paris Agreement.

Growing interest in climate budget tagging and tracking can be seen across Africa. Broadly speaking, climate budget tagging may aim for any combination of the following objectives:

- Assist the government in *reporting on climate policies*, hoping that this will raise *awareness and accountability*, and influence the revision of strategies and policies;
- Increase the *prioritisation* of programmes that deliver mitigation or adaptation along with social resilience and just transition, by providing information to inform budgeting decisions; and
- Help improve the *design* of expenditure programmes to improve their effectiveness in delivering equitable responses to the climate crisis in mitigation, adaptation and resilience.

These objectives are not mutually exclusive and can be sequential (for example, a government may opt to begin by introducing a fairly simple tagging system which is used for reporting and awareness-raising purposes initially, but later introduce additional elements to address expenditure programme design and impact considerations). Which of these objective(s) a tagging system serves will have material influence on the design of the system. Key design considerations centre around the coverage of the system (which levels of government, and which functional sectors should be included), as well as how climate change is defined (using international definitions or those derived from domestic policies and local context), and the approach to weighting budget lines to capture different degrees of climate relevance and societal impact.

While only a handful of countries have an operational tagging system at the moment, other countries have plans to introduce them, or expressed interest in doing so over the course of the exchange. Ghana is one such country which has had a climate budget tagging system in place since 2018. The Ghana Ministry of Finance shared how they introduced their system as a means of tracking implementation of the national climate change policy, including their NDC, which, without a dedicated budget tag, was almost impossible to do in the existing chart of accounts and financial systems. It enabled the Ministry to identify, for example, that insufficient priority was being paid to climate change in the budgets of some districts, enabling targeted awareness-raising interventions. Nonetheless, the Government is aware of some remaining blind spots in their climate budget tagging system, in particular relating to off-budget funds. Rwanda described how they have yet to introduce climate budget tagging, but intend to over the coming budget year to enable reporting against the country's NDC, and potentially to help attract more external co-financing for climate programmes. The Ministry of Finance there recently introduced a climate and environment budget statement, where line ministries are required to fill in information about the performance and impact of the budget submissions vis-à-vis climate change, which is expected to provide a sound analytical basis for the establishment of the budget tag. In time, the Government would like to expand this to also cover private sector spending and donor/civil society organisation (CSO) climate contributions.

The monitoring and management of climate fiscal risks is another area where experience is emerging, with interest linked in particular to the risk of climate-induced disasters. For example, the National Treasury of South Africa shared that they review fiscal risks – including those emanating from drought – as part of the preparation of the Medium-Term Budget Strategy. Meanwhile, the Government of Malawi prepares an annual Fiscal Risk Statement, which includes disaster-related liabilities from storms, floods and droughts, and while this remains an internal document at present, it nonetheless is used to inform allocations for emergency contingencies. In some cases, governments are

8 CABRI, 2021

looking to transfer the risks of climate-related disasters off their balance sheets, and for this purpose the African Risk Capacity (ARC), a specialised agency under the African Union, offers parametric sovereign insurance to cover some of the losses and damages caused by drought (with products for cyclones, epidemics and floods currently under development). ARC also offers a customised early warning system and support to governments for contingency planning, with specific emphasis to uphold gender equality in all its activities and operations. Their objective is that this enables countries to strengthen their disaster risk management systems and access rapid and predictable financing when disaster strikes. ARC mobilises capital from the private sector, primarily through insurance and reinsurance, and in reaching a large number of investors it aims to bring competition, and ultimately lower premium costs, to its client governments. However, some African governments still report challenges in affording insurance premiums in the context of limited fiscal space, calling for additional donor assistance in this regard. To date ARC has provided over US$61 million in payouts, supporting over 2 million affected people.

Climate-related revenue reforms are not presently widespread across the continent, but there is growing interest in mechanisms such as carbon taxes and green bonds, particularly in the wake of the COVID-19 economic slowdown as it converges with the climate crisis. South Africa is paving the way in terms of climate-responsive tax policy, with a carbon tax that was signed into law in 2019. Based on the "polluter pays" principle, the tax is designed to ensure that firms and consumers take climate costs into account in their production, consumption and investment decisions. In this way, it is designed to drive down GHG emissions and is therefore a key pillar in South Africa's efforts to meet its NDC commitments. In addition, the carbon tax provides an additional revenue stream for the Government, the proceeds of which are soft-earmarked[9] towards enhanced free basic energy, improved public transport, and a carbon capture and storage rebate (the National Treasury tends to avoid hard earmarking due to the rigidity it creates). The evolution of South Africa's carbon tax points to the complexity of such a reform; consultations there started in 2006 and it wasn't until nine years later that the law came into force. Some of the complexities include considerations about how to protect domestic industries from international competition following the tax, and how to protect low-income households from energy price increases.

Nigeria and Seychelles shared their experience of using sovereign green and blue bonds to raise capital for key investments to respond to their specific climate impacts. In the case of Nigeria, two sovereign green bond issuances have been made to finance renewable energy and afforestation and reforestation investments, while in Seychelles, a blue bond raised funding for marine conservation and restoration projects and the rehabilitation of mangroves. The countries shared valuable insights from these experiences, including the need for strong leadership, close partnerships with national stock exchanges, and the value of complementary reforms in climate-sensitive PFM, such as climate budget tagging as a means of identifying relevant investments in the budget. Some of the challenges include balancing the need to offer a rate of return which is attractive to investors, but not so high as to force the government to increase user fees on funded projects (for example, through higher renewable energy prices), which creates inequitable barriers to marginalised and poorer households. Furthermore, the discussions covered a potential risk of funding disruptions and delays to key programmes when they are reliant on releases from the bond, which may come behind schedule.

Extending climate integration reforms to subnational governments has the potential to strengthen a country's fight against climate change with local contextualised response and budgeting, but this depends on the independence and autonomy of local governments. Guinea, for example, has in recent years introduced a fiscal transfer which shares 15% of revenues from mining with local communities, to be put at the disposal of the mayor. In general, these funds can contribute towards anything in the local investment plan, and while guidelines state the investment plans should have a chapter on climate change measures, not all of them do. In South Africa, the National Treasury has more leeway to ensure provinces make enough budget provisions for climate change, including through establishing a provincial budget subprogramme on climate management under which the Treasury can track spending. Furthermore, provincial Medium Term Expenditure Framework guidelines emphasise the importance of budgets which are sensitive to climate issues, and regular budget visits by National Treasury to provinces, as well as a regular provincial benchmarking exercise which allows them to monitor progress, and through which they classify provinces into either advanced, emerging or beginner groupings based on the extent of their climate-informed budget processes.

From a Government perspective, climate budget integration reforms are generally being driven from the Ministry of Finance, with other agencies – like the Ministry of Environment or Climate Change – being brought in for technical inputs; but beyond this the important contribution of accountability actors (such as Parliament, civil society and the Auditor-General's Office) was discussed. Presentations from CSOs from Bangladesh, Ghana and Uganda illustrated the importance of engaging civil society in the gender *and* climate budgeting and

9 Soft earmarking involves having certain budget allocations notionally linked to the carbon tax revenues.

finance agenda. Some of the key lessons learned across countries include: taking time to develop constructive relationships with government officials; identifying policy gaps and using these as opportunities for entry points; and how communicating through simplified language can help civil society understand the bigger picture. Overall, the engagement with accountability actors around climate budgeting is relatively new for many governments in Africa, and lessons can be taken from looking toward the experiences in Asia.

With the growing understanding of the importance of gender considerations in furthering progress on climate change, as well as clear synergies in the approaches to mainstreaming gender and those of climate change, there are evident benefits to addressing these concerns in unison. Governments and their partners are increasingly moving in this direction. For example, work ongoing in the Gambia to introduce gender-responsive budgeting and climate budget tagging may become a model for other governments to emanate, jumping both hurdles together. Meanwhile, the UNDP is currently working with a number of pilot countries to integrate gender into their NDCs, with lessons emerging that could potentially be replicated in other countries currently reviewing their NDCs, for example concerning the benefits of using existing gender focal points in the process to ensure horizontal and vertical coordination. At the same time, the UNFCCC shared an update on the Lima Work Programme on Gender. Under this initiative, a gender action plan has been developed which prioritises efforts to operationalise gender-responsive climate policy, and strengthen the capacity of women to contribute to it and benefit from its responses. Meanwhile, work is also ongoing to develop indicators to measure the gender responsiveness of climate finance, which in the future could be integrated into the monitoring systems of international climate funds, as well as governments' own climate budget tagging systems. Beyond this, the UNFCCC is committed to deepening and expanding the evidence base on the effectiveness of gender-responsive climate adaptation and mitigation investments.

4. COVID-19 challenges and opportunities for green recoveries

The COVID-19 pandemic has undoubtedly created substantial challenges for governments in Africa in furthering the climate integration agenda, but it also presents some opportunities. In the peer exchange, the United Nations Economic Commission for Africa noted that the pandemic has led to a 3% contraction in the GDP of African economies, and with this has come significant tightening of fiscal space. Fiscal deficits peaked at 8.3% in mid-2020 and are not expected to become positive until 2022. To finance this shortfall, African economies are increasing their debt burden, typically at less favourable interest rates than Organisation for Economic Co-operation and Development (OECD) countries have access to. In this context there is a risk that limited resources will be directed only towards immediate pressing needs, potentially squeezing out resources for the longer-term, slow-onset climate resilience agenda. Without mechanisms to address this, widely mooted inclusive green recoveries from COVID-19 may remain out of reach for many African economies. This point was echoed by Mozambique, who reflected on the funding constraints which were limiting the Government's ability to deliver critically needed social services, and emphasised the growing need for international assistance to meet climate spending needs.

Climate change was not halted by COVID-19, and financing for it cannot wait for Africa's public finance systems to be fully restored to pre-pandemic levels. This underpins calls for international climate finance to be augmented and diversified. SIDA notes that the domestic slowdown in Sweden is unlikely to have a material impact on the contribution the country makes to international climate change assistance in developing countries, and other OECD Development Assistance Committee members also recently reaffirmed their climate finance commitments, while the new US administration is signalling a return to climate change negotiations and financial commitments. Discussions also covered other potential opportunities for financing green recoveries in Africa, including carbon offsetting through the Clean Development Mechanism of the Kyoto Protocol, where developing countries can sell carbon credits to developed countries on the basis of domestic mitigation investments in areas such as energy and infrastructure. Debt swaps also hold promise, where lenders agree to partially forgive or restructure debt contingent on domestic investments in climate change, as has previously been undertaken in Seychelles. The World Bank and International Monetary Fund are also discussing the potential for new "performance-linked" lending instruments which tie interest rates or refinancing mechanisms to the achievement of sustainability goals, which could include countries' NDC commitments and implementation.[10]

10 See, for example, World Bank blog post, 'My word is my bond: Linking sovereign debt with national sustainability commitments', published on 11 February 2021.

5. Conclusion

The peer learning and exchange served to demonstrate that there is a lot of appetite to take forward the integration of climate change into budgeting across many African countries. While Asia has had more experience is this field, Africa is ready to scale up and build on learning emerging from different regions and across the African continent. It remains, however, a relatively nascent field globally, but the fact that it is gaining traction in the PFM community is evident through the recent launch of a climate module under the Public Expenditure and Financial Accountability (PEFA) assessment framework, which provides a standard methodology for assessing how well PFM systems can support the implementation of government climate change policies.

The pace and direction of reforms to integrate climate change into PFM systems in Africa varies substantially, and there is no "one size fits all" approach. The countries which seem to be further along in this agenda gave accounts of reform approaches that were gradual, iterative and context-specific, building on existing PFM systems and their functionality. They also expressed the value in anchoring reforms in international commitments such as NDCs and the UNFCCC Gender Action Plan as well as regional climate and sustainable development agendas, and expressed optimism that such measures could ultimately strengthen their hand in the climate negotiations.

Gender will need to be at the forefront of efforts to tackle climate change, as will positive collaborations with accountability actors. Gender-differentiated issues and impacts from climate change persist, with women on the whole more vulnerable because of their marginalised rights, resources and position in society, whereby they receive less education, have fewer economic opportunities, and less say in decision-making processes (from household to national policy level). Addressing this necessitates mobilisation of all groups and individuals of society (women, men, youth, Indigenous peoples, migrants and others) as agents of change to respond. Efforts to address the climate crisis through public spending will be limited if they do not simultaneously consider and respond to systemic gender and societal inequities across, but nuanced in locales of, the African continent. Moreover, this is an area where objectives of the State and of civil society have the potential to be aligned, and so governments should engage with CSOs and oversight actors as allies. Continuing to share experiences and knowledge of good policy and practices, from national to local levels, will enhance and build better systems across communities, countries and in the whole of Africa.

Moving forward, through the IBFCCA programme, CABRI, IBP, IIED and UNDP intend to continue to support ministries of finance to integrate climate change into PFM through a combination of country actions, research, peer-learning and exchange, technical assistance, capacity building and political engagement with key accountability actors.

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