
Climate Finance

Regulatory and Funding Strategies for Climate Change and Global Development

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Bringing Developed and Developing Countries
Together in Climate Finance Bargains
Trust, Governance, and Mutual Conditionality

A



Meeting Developing Country
Climate Finance Priorities

Chapter 16



Developing Country Concerns about
Climate Finance Proposals
Priorities, Trust, and the Credible Donor Problem

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Key Points

- The long history of mutual mistrust between North and South as donors and recipients of development aid is a challenge for climate finance negotiations.
- A stable and secure pool of climate finance is essential. The developed countries must recognize that their promises of future climate financing need to be credible and locked in from volatility or backsliding.
- Trusted institutions for decision-making and disbursement of finance are essential, and the Bretton Woods institutions may not be the answer.
- Effective monitoring, verification, and compliance mechanisms are needed not only for emissions reductions, but also for commitments on financing and technology transfers.

*The North-South Negotiating Gap on
Climate Finance and Institutions*

While there is much variation among different developing and developed countries, overall there is a real North-South gap in climate negotiations. Current proposals on climate financing do not do enough to overcome the lack of trust and mutual credibility between developing and developed countries. This essay analyses the priorities and concerns of developing countries and proposes three planks for a bridge across the gap.

The lack of trust between developed and developing countries reflects not only a lack of appreciation of each other's domestic political commitments and constraints, but also a history of bad faith in the making and implementation of global commitments on development, climate, and institutional reform.

Developing countries view calls to stabilize and reduce their greenhouse gas (GHG) emissions as both illegitimate and a threat. They consider the demands illegitimate because rich countries are primarily responsible for the historical stock of emissions, the atmospheric concentration of which is causing global warming. The calls are a threat because curbing emissions could undermine the growth necessary to lift millions out of poverty. With 1.4 billion people living in extreme poverty, poverty reduction for developing countries is the priority. Any desired action against climate change has to be reconciled to that imperative.

Absent sufficient financing, any commitment to curb GHG emissions would limit the ability of developing countries to increase their energy supply, a central part of their efforts to reduce poverty. About 1.6 billion people in developing countries live without electricity, and 2.5 billion lack access to modern energy sources. Even in fast-growing China and India, more than half of the population relies on traditional biomass for cooking. The easiest and fastest way to increase energy supply under current circumstances often involves the construction of plants with high GHG emissions. However, the provision of financing to improve the efficiency of existing and oncoming modern energy infrastructure will offer a potential win-win situation: many developing countries may be able to use financing from industrialized nations to reduce emissions while increasing economic growth rates. Accomplishing this goal will require substantial technology development, diffusion, and transfer, in addition to financing.

Many developing countries also believe that industrialized nations have not paid sufficient attention to the challenges of adaptation. The impera-

tive for poor countries to adapt (rather than mitigate) strengthens every day as efforts to mitigate by rich countries falter. Yet adaptation is often treated as a side issue, and current spending on adaptation (about USD 1 billion) is a fraction of the estimated requirements.

From a developing country perspective, the demands and priorities of rich countries assume that only their own internal politics matters—and that large developing countries, instead of reducing emissions, are simply stalling. Developed countries seem to insist on setting demanding conditions on recipients of climate financing, and anyhow to be reluctant to provide financing without both setting eventual caps for developing countries and lowering competitive costs for their own economies. Developing countries take the view that since rich countries have repeatedly failed to meet their past commitments on development assistance, any new climate financing proposals will lack credibility unless there is adequate accountability of developed countries to keep not only their emissions commitments, but also their financing commitments to developing countries. Donors have reduced funding or altered conditions even in cases where recipients met specified conditions. Where provided, funding was volatile and unpredictable, thus undermining their best-laid plans. Making commitments for reducing emissions or adopting climate-friendly policies without financial guarantees is, therefore, not politically acceptable to developing countries. Current or potential large emitters among developing countries have some real negotiating power to insist on these demands.

Several developing countries have proposed unilateral climate-friendly measures. China aims to supply 40% of its energy from renewable sources by 2050. Other announcements include Brazil's on reducing deforestation, Mexico's and South Africa's on emissions reduction and stabilization, and India's on energy efficiency and the development of renewable energies. Yet, all are hesitant to sign an agreement that would cap their future emissions without assurances that they will receive substantial technological or financial support from developed countries. They have received little such support thus far.

Developing countries have set out a broad agenda for financing and technology transfer. The G-77 and China have proposed a financial mechanism accountable to the United Nations Framework Convention on Climate Change (UNFCCC) with balanced representation and direct access to demand-driven funding. They also propose a technology mechanism, including a multilateral fund under the UNFCCC, and they call on industrialized nations to divert as much as 1% of their gross national product

to help finance emissions-reducing technology projects in the developing world. They want multilateral mechanisms to cover both the full costs (for preparing national communications, patents, and license fees, and for adaptation) and full incremental costs (for mitigation actions, transfer of low-carbon technologies, R&D, and for building institutional frameworks).

In the eyes of developing countries, the approach of developed countries has been inadequate and perhaps even counterproductive. Developed countries seem determined to use the World Bank to channel funding, and even then not the full multilateral International Bank for Reconstruction and Development (IBRD) mechanisms but climate-related trust funds. This is serious because global public financing cannot be avoided. For instance, even with an intervening carbon bank that finances abatement projects in developing countries and sells offsets to developed countries at a profit, 30–45% of annual financing needs would have to be covered using public sources. Moreover, it is unlikely that the sums generated would be sufficient for adaptation activities. Another proposal, which leverages pre-committed emission reduction plans in developing countries to generate loans in the carbon market for mitigation activities, would still raise questions about the predictability of funding in future. In a 2009 submission to the UNFCCC, the United States recognized the need for financing, technology, and capacity-building support but left the section intended for spelling out financing arrangements completely blank.

Holding both sides to account in the financing relationship will be a key element for any financing mechanism to be both politically acceptable and effective. From the above discussion, three principles emerge for climate financing mechanisms and their governance.

1. Ensure the Creation of a Secure Pool of Climate Finance

There must be a credible basis for confidence that a huge gap will not emerge between promised and delivered financial assistance. Developing countries seek guarantees. As the Algerian delegate argued at the Bonn climate meeting in March 2009: “A lottery would not get much ticket sales if it disclosed the prize *after* the draw.”

Estimates of the amount of funding required to adequately address global warming vary wildly. A draft report by the UNFCCC’s Expert Group on Technology Transfer estimates that additional annual spending on mitigation technologies of USD 262 billion to USD 670 billion would

be needed by 2030 (current spending ranges between USD 77 billion and USD 164 billion a year). Due to the variety of estimates, developing countries are hesitant to agree to a set amount of financing, calling instead for industrialized countries to cover the full incremental costs of low-carbon technologies. In light of these requirements, the institutional response so far has been inadequate. Since 1991, the Global Environment Facility (GEF) has allocated only USD 2.5 billion to climate projects and claims to have leveraged another USD 15 billion in co-financing. Its “strategic program,” approved in Poznan in December 2008, would devote only USD 50 million to scale-up transfers of technology.

One way to overcome this is to create mechanisms that assure financing without appropriation or interference at the national level in donor countries, such as a carbon tax, aviation, and/or maritime levies, auctions of emission allowances, or direct development assistance. Regardless of the option(s) chosen, the funding would have to be available through a multilateral mechanism to reduce unpredictability and unexpected conditionality of financing.

2. Use (or Build) Trusted Institutions for Decisionmaking and Disbursement of Finance

Participation in climate mitigation will not be secured only by financial incentives. Equally vital is the structure of representation in decisionmaking. Many industrialized countries favor the World Bank as a financing and disbursement mechanism. Developing countries have long expressed dissatisfaction with the lack of votes and voice accorded to them in the International Monetary Fund (IMF) and the World Bank, which gives industrialized countries a majority of votes and the United States veto power. Similarly, the Global Environmental Facility (GEF) lacks legitimacy among developing countries because its governance structures give undue weight to the influence of developed countries. Most developing countries have rejected the GEF as a financial mechanism, choosing to treat it only as an operational entity.

The industrialized countries’ grip on the IMF and World Bank has led developing countries to exit when they can, in practical terms, from each institution by not borrowing and not taking advice from the institutions (whenever they can afford not to). In climate change governance, exit of this kind could render shared objectives unattainable.

A more specific concern is whether developing countries would have control over the choice of policies and technologies they adopt. The World Bank's Clean Technology Fund (CTF) has been held hostage to US politicians and organizations opposed to financing coal-based technologies, even if the potential efficiency gains and emissions reduction potential for developing countries are large. The CTF's operating mandate requires it to respond to country-owned strategies. Yet, domestic politics in donor countries threatens to close the option of multilateral support for large-scale energy investments in developing countries.

Many of these problems could be resolved through appropriate governance structures that would provide greater representation and control to developing countries. For example, the Adaptation Fund model has managed to avoid replicating the World Bank or GEF representation. Its board, comprising 16 members and 16 alternates, represents the 5 United Nations regional groups (2 from each), the small island developing states (1), the least developed countries (1), Annex I Parties (2), and non-Annex I Parties (2). The CTF also has balanced representation but is hobbled by domestic politics. A new financing and/or technology mechanism would need a similar structure. However, formal seats at the table or voting rights are not enough to secure effective voice and influence. Also important are: the role and selection of senior management; the staffing and location of an organization; the decision-making rules (or form of consensus decision-making); and the capacity of developing countries to identify their own priorities and to hold institutions and their representatives to account. Additionally, proposals to its board should be reviewed by an independent expert committee.

3. Develop Effective Monitoring, Verification, and Compliance Mechanisms for Financing and Technology Transfer Commitments

A third important element of financing mechanisms concerns monitoring and verification. Monitoring financial and technology transfers might be technically easier than measuring emissions. To date, however, reporting on financial contributions has been mixed at best thanks to data deficiencies, multiple sources of funding, and inconsistencies in definitions.

Industrialized countries have emphasized the importance of effectively monitoring emissions. However, developing countries are concerned about

the costs of complying with verification systems, as well as potential asymmetries in the application of such systems. In the past, verification and compliance programs have either been ineffective or been applied more harshly against developing countries than against industrialized countries. For example, in the World Trade Organization (WTO), the Trade Policy Review Mechanism (TPRM) has done little to bridge the gaps in information about compliance that would be of use to developing countries. Similarly, the IMF surveillance process is a robust policeman of smaller, poorer developing countries but has little if any effect on wealthy countries. An emissions compliance regime should avoid similar inequities.

A credible financing mechanism in the climate regime would need new institutional features for monitoring and evaluating the effectiveness of financial flows. First, self-reporting by member states should be supplemented by more frequent institutional reporting to measure the origin and destination of financial flows. One option is to use the Organisation for Economic Co-operation and Development's (OECD) Creditor Reporting System. But, if the WTO's new aid-for-trade monitoring mechanism is a precedent, developing countries would demand a dedicated system under the UNFCCC to ensure there was no double counting of assistance provided. Secondly, the data must be also analyzed to evaluate the impact of financial flows. Here the experience of the World Bank and regional development banks in project evaluation could strengthen reviews held within the UNFCCC. Third, knowledge networks could be established at a regional level to facilitate the sharing of information and experience across countries and build capacity for monitoring and evaluation. Finally, compliance-oriented peer review procedures would be needed within the UNFCCC to apply pressure on developed countries to comply with commitments. Discussions about the timeliness, adequacy, and impact of financial transfers should be included in extensive reviews similar to those conducted for emissions and implementation of commitments under Article 8 of the Kyoto Protocol.

FURTHER READING

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Developing Countries and a Proposal for Architecture and Governance of a Reformed UNFCCC Financial Mechanism

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Key Points

- There is a pressing need for wholesale reform of the financing arrangements under the UNFCCC at Copenhagen, in terms of scale of funding as well as scope and method of governance structures, with ties to compliance.
- The current situation of financial support for emissions reduction and adaptation support is characterized by a great number of funds with complex administrative processes, minimal transparency or accountability, and conflicting mandates that do not necessarily address or respond to developing country concerns. These funds collectively do not have the capacity to change the course of global development towards a lower-carbon path.
- New efforts to address these issues need to deal with the historical baggage of distrust between rich and poor countries; frame the negotiations within the principle of the legal obligation and compliance to replace the present de facto voluntary system; significantly increase the ability of the UNFCCC to carry out its objectives; bring some measure of harmony and good governance to the multiplicity of funds; and draw significant interest from the private and public sectors, bearing in mind the historical sources of finance for the Convention's purposes.

Introduction

As has been highlighted in a number of chapters in this book, the engagement of developing countries is fundamental to the success of any post-2012 climate regime. Developing country engagement is inextricably linked to issues of governance and institutions. This link is an issue both legal as well as practical. It is a legal issue, because developing country engagement is based on the principle of common but differentiated responsibilities, as well as on the obligations and commitments spelled out in Article 4 of the United Nations Framework Convention on Climate Change (UNFCCC). This Article spells out the commitment of developed countries to support developing country efforts. And it is a practical issue, because without well-designed, well-functioning, and responsive governance institutions—including a financial mechanism that can facilitate and implement mitigation and adaptation funding—the chances of significant developing country engagement are remote. Without this engagement, it will be practically impossible to successfully mitigate climate change.

Flaws in Governance = Flaws in Implementation

Many years ago, developed countries agreed to support the climate change mitigation efforts of developing countries. However, they argued that there was no need for a new financial mechanism, as they believed the Global Environment Facility (GEF), established in 1991, would be adequate. However, it is now obvious to developed and developing countries alike that the scale of funding and the current operational arrangements for implementation are inadequate. The Financial Mechanism—which is meant to play a central role in supporting the implementation of the Convention—is in need of major reform. The reform is required because (a) the severity of the climate change challenge requires a much greater scale of action and response than at present, (b) the need and urgency to act now rather than later to avoid even higher costs and hardship, and (c) the mandates of the Convention.

The inadequacy of the current arrangements of the financial mechanism of the UNFCCC has given rise to a fragmented, complex, and inefficient system of finance for climate change and implementation of the Convention that is characterized as follows:

- A large number of funds and financing instruments have been created to address specific climate-related objectives. Most of these are outside of the Convention, and many of them fund pilot projects rather than large-scale operations.
- Generally, each fund has its own rules of procedure and its own governance structure. Many of them lack transparency and accountability.
- Because of the operational complexity of many of the funds, dedicated experts are required at the national level in order to access and benefit from them. This has major consequences and adds pressure to already weak national monitoring and reporting capacities of developing countries.
- These funds and financing instruments have immense direct and indirect transaction costs.
- The objectives of many of these financing instruments and funds are often formulated neither to respond to the demand or needs of developing countries nor with their participation.
- A majority of these funds and financing instruments prefer to fund projects rather than programs or sector plans of action. This adds to the complexity and transaction costs while at the same time diminishing the relevance and impact vis-à-vis the needs of many developing countries.
- While carbon finance (particularly the offset market) initially had great promise to engage developing countries, it ended up benefiting a small handful. Few projects supported sustainable development or transferred technologies as was initially intended.
- Adaptation—the priority for most developing countries—is vastly underfunded and difficult to attract funding and investment as it cannot be easily integrated into the global carbon finance system.
- As currently designed, the financial architecture neither creates the proper incentives for the transformation toward lower-carbon economies and societies nor facilitates implementation of strategies, plans, programs, and projects for those that do want to take action.

The Challenges

Climate finance negotiations have been seriously affected by the struggle between those who want the public sector to be the major—and even

perhaps the sole and centralized—source of funds and those who want the private sector to be the principal vehicle, leaving the public sector to finance only those areas that the private sector cannot adequately fund.

Because of the scale of the effort needed, the solution can only lie somewhere in between. It is impossible to conceive of one public-sector fund that would support all required action on climate change throughout the developing world. Equally important, it is also naive and ill-informed to expect that the current fragmented world with a multiplicity of funds can do the job of supporting the developing countries adequately and, perhaps even more important, that without significant public-sector involvement and support, many of the needed private-sector investments will ever happen, or happen in the areas where they are most needed.

So what should an ideal negotiation seek to achieve? Before even considering the question, the UNFCCC negotiators need to be aware of a few realities that are difficult to ignore and that create a baseline for the negotiations. This baseline and the facts that contribute to it can be characterized as follows:

- One of the principal factors, if not the principal one, contributing to the level of distrust between rich and developing countries has been the issue of finance (the lack of it) and the unhappiness with the present arrangement within the Convention.
- Funding within the Convention has had little relation to issues of compliance to Article 4 of the Convention, a situation that is most likely to change drastically in the post-2012 financial regime of the Convention.
- The level of funding provided has been insignificant when measured against the needs and magnitude of effort needed.
- The current uncoordinated and fragmented world of climate change funding, while often more counterproductive than helpful, is in many ways also a welcome sign of the interest and willingness of many to invest heavily in climate-change-related activities.

A successful negotiation on the finance and implementation aspects of the Convention would therefore need to (a) realistically take into account the historical baggage of distrust between rich and poor countries that now exists and try to address it; (b) frame the negotiations within the principle of the legal obligation and compliance to replace the present *de facto* voluntary system; (c) create a financial architecture that places top priority to

giving the Convention the authority to predictably raise significant revenues to levels that are commensurate with the challenge and to allocate revenues fairly in a way that places the power in the hands of developing countries; (d) create a financial architecture that is given the means to force consistency and harmony amongst the multiplicity of existing funds so as to be part of the overall compliance regime; and (e) create a financial architecture that provides incentives, influence, and guidance for private-sector finance to flow towards climate-friendly investments.

Conclusion: A Framework for Negotiations

As long as the debate on finance and implementation of the Convention remains focused on whether it should be mostly public- or private-sector supported and funded, or centralized versus decentralized, there is little chance that the negotiations will advance in benefit of the Convention. An alternative framework is one where the negotiations would focus on the principal objectives that the financial and implementation architecture would need to achieve, establishing some basic principles that would need to be fulfilled, and matching them to the present realities as the basis for that design.

Funding for climate change today derives from three principal sources and levels. The new financial architecture should build on this reality and adjust it in order to enhance the objectives of the Convention:

- Level I: *The resources that flow through the UNFCCC and that are under the direct authority of the Conference of the Parties (COP).* The only financial resources under the authority of the COP are those managed by the GEF, the sole operating-entity of the Convention up to that date. At issue are whether to maintain the present operating-entity system; what the role of the GEF should be in the new regime; and whether all compliance-linked funding would need to flow through or be coordinated by the new operating-entity system. Whatever the decision, the resources under this category—Level I—would be applied directly to the compliance mechanism and to the monitoring, reporting, and verification (MRV) system. It would consist of new funding windows to support areas such as mitigation, adaptation, technology transfer, and capacity building. Level I would be supported by a governance structure under the UNFCCC,

with an Executive Board acting as the new operating-entity under the authority of the COP and based on the principle of subsidiarity. As such, it leaves the decision of where to apply the funding (i.e., how to disburse) to countries. The governance structure would need to include national Climate Change Funds and implementation hubs that are linked to the UNFCCC system, the MRV system, and the system of compliance. The institutional structures would vary according to the needs and capacities of countries. But as a minimum, these national entities would need to have the capacity to assess needs and priorities and be in a position to make decisions on disbursement to programs and projects with the most potential for addressing the various thematic area needs. These national entities would also have the responsibility to coordinate and harmonize the disbursement of funding, to promote stakeholder consultation, and to ensure that the climate change programs and projects funded are well-embedded in national development strategies and plans and preferably in nationally prepared climate change strategies or plans.

Some initial target or baseline for this level could be established for 2010 with an agreed rate of increase over a 5-year period. These initial resources would be directed to attend urgent priority needs in adaptation, particularly for countries that are most vulnerable; to fund all National Adaptation Plans of Action (NAPAs); to kick-start an urgent program on reduced emissions from deforestation and degradation (REDD); to support the implementation of Nationally Appropriate Mitigation Actions (NAMAs) as they enter into the mainstream; and lastly, activities in support of technology transfer and capacity building which in turn should become the dedicated and sole areas of responsibility of a new and reformed Global Environment Facility.

- Level II: *The many dedicated public-sector international funds that have been created but that are now outside of the authority or influence of the COP.* It is difficult to imagine that the present chaos of multiplicity of funds would remain unregulated. It is not only ineffective from the point of view of the Convention objectives but also extremely inefficient. Should negotiators, therefore, insist that all of these funds go through the UNFCCC and be under the direct authority of the COP? This would be hardly realistic, particularly since most of these funds are dedicated to creating and strengthening the enabling environments for action on climate change. What is more

important is that these funds be placed under the overall oversight of the UNFCCC, which would have the responsibility to provide guidance and assess whether these funds are adhering to the principles established under the agreements reached in Copenhagen. Ideally, a system to link these funds to compliance and the MRV system should be created with the caveat that the principal avenue for compliance-related funding is Level I. Level II should be seen as complementary to the system of compliance, and one that would be several times as large as Level I in the initial stages as countries build their capacities, strategies, and plans of action. With time, this level should decrease with Level I increasing in order to support implementation.

- Level III: *The private-sector and carbon finance that now flows unregulated and often operates with little transparency, oversight, or guidance.* This is by far the largest source of resources for implementation of the Convention. But the full potential of this resource will never materialize unless Levels I and II are organized to break down market barriers; create the enabling environment, policies, and regulations; and increase the capacity of countries to influence and direct these resources to climate-friendly investments and climate change priorities. Levels I and II would concentrate their efforts in leveraging these resources to a scale several times higher than Levels I and II.

A truly effective financial architecture would be one that would mobilize and influence the flow of resources on a scale several times that of what exists today, and that would provide a framework that can enhance consistency, harmonization, and investment promotion in climate-friendly investment at the national level.

FURTHER READING

For more detailed information on the Reformed Financial Mechanism proposal, see Benito Muller and Luis Gomez-Echeverri, *Reform of the UNFCCC Financial Mechanism: Part I: Architecture and Governance* (Oxford: Oxford Institute for Energy Studies, April 2009).



Climate Change and Development
*A Bottom-Up Approach to Mitigation for
Developing Countries?*

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Key Points

- In the immediate future, bottom-up approaches, such as NAMAs, for developing countries may have substantial environmental advantages over top-down approaches.
- Top-down approaches based on emission caps risk creating counter-productive incentives, such as incentives to set overly high emissions targets or to avoid early action in order to receive greater financing and higher caps later.
- Top-down approaches may in practice reduce, rather than increase, the predictability of emissions levels and of emissions reductions against BAU baselines or meaningful targets.
- Strengthening domestic institutions in developing countries is needed for successful low-carbon development; strategies to do so are an essential part of a low-carbon development and financing program, but are underemphasized in top-down approaches.

A top-down approach—specifically internationally specified and binding national targets and timetables—has long been the preferred position of environmental advocates. But bottom-up approaches, such as policy measures to be devised on a country-by-country basis, have also been part of the policy grammar of the climate negotiations. In the process

of fleshing out the Bali Action Plan, one articulation of a bottom-up approach, nationally appropriate mitigation actions for developing countries, is attracting renewed support. What should we think of such bottom-up proposals?

Background: The Push toward a Top-Down Approach

For those who put climate change mitigation first (as opposed to those who seek to preserve sovereignty or emphasize untrammled economic growth), a focus on targets and timetables is an article of faith. Indeed this is the best way of ensuring meaningful action from Annex I countries. Many of these advocates also believe that some form of hard targets is the best way of inducing serious mitigation from the developing world. They react with considerable unease to the political support for a formula of top-down caps for the North and bottom-up mitigation actions for the South. They thus welcome proposals to hasten the adoption of some sort of caps for the South, such as incentives for early adoption of caps, offers of no-lose targets, and the like. For example, early adoption of a commitment to reduce emissions below projected emissions could trigger rewards such as eligibility to sell the resultant emissions reductions in a carbon market. Alternatively, some call for embedding developing country mitigation actions in a binding planning framework to enable predictability of action. Under this approach, countries would develop bottom-up measures, but then be asked to aggregate these into a larger national plan, to which they would be held accountable.

While there is no doubt that caps for all would, in theory, be the best environmental outcome, in the current negotiating context, focusing in the short run on explicit caps (or the implicit caps of climate plans) for developing countries is a misguided policy. It will not produce predictability of future emissions from current baselines, and in the short to medium term may be misguided for environmental reasons, quite separate from all the conventional arguments about differentiation, equity, historical responsibility, atmospheric space for economic growth, and the like.

To begin with, what are the arguments for inducing developing countries to take on some form of caps or agree to develop binding plans? The primary argument emerges out of climate science as summarized by the Intergovernmental Panel on Climate Change (IPCC). If, as a global community, we are to restrict temperature rise to between 2 and 2.4°C,

we must reduce emissions by at least 50% from their 2000 levels by 2050. Even if the North does take on ambitious absolute caps, additional limitations must be accomplished in the South to achieve a 50% reduction. Taking the next step of converting the de facto cap for the South as a whole to national-level caps, however articulated, is arguably necessary to ensure that the global community is on track toward this global goal. A national-level cap, even if not articulated in terms of absolute emissions, will also send economy-wide signals, and enable integration with global carbon markets. Thus, it is argued, caps or binding plans must be adopted in order to ensure the measurability and predictability required to maximize incentives for mitigation action and to achieve ambitious climate goals.

Both parts of this conclusion are questionable. Under the prevailing conditions of institutions and governance in developing countries, top-down approaches may well not be the best way to incentivize low-carbon development. Moreover, efforts to quantify developing country contributions toward global emission reduction goals may, ironically, discourage the desired early climate mitigation actions and undermine predictability. I refer to this effect as a climate policy uncertainty principle. Below, I expand both these arguments.

Low-Carbon Development Needs Effective Institutions in Developing Countries

To understand the prospects for low-carbon development, we first need a perspective on the process of current and future development in developing countries. Development, I suggest, is not just economic growth from a lower base, but a qualitatively different process than economic growth in industrialized countries. A now substantial literature suggests that successful development is closely tied to the nature of economic, social, and political institutions. By institutions I mean the rules of the game, both explicit and implicit, that guide and shape incentives for decisionmakers. Jump-starting development requires appropriate institutional change, and under-development is to a significant extent a result of persistent and poor institutions.

Under these conditions, top-down measures such as emission caps designed to change relative prices, signal economic opportunity, and stimulate actors to capture efficiency are blunted and can even produce distort-

ing effects. Where existing institutions limit choices or create perverse incentives, inducing institutional change through the political process should be the primary task. Absent this change in the underlying incentives, shifts in relative prices are likely to accomplish little.

The Indian electricity sector provides a good example. For at least a decade, there have been considerable economic gains to be had by reforming the Indian electricity sector, but little has changed. The sector is trapped in a vicious cycle of high loss levels and theft, a growing subsidy burden, and declining service quality. Reversing this cycle would lead to considerable financial, social, and environmental gains through more efficient and equitable electricity production and distribution. But reform of Indian electricity has largely failed due to the interlocking of political interests and governing institutions in the sector. Climate-driven economic incentives would increase the potential economic gains from reform of the electricity sector. They would, however, do little to address the entrenched politics and institutions that block their achievement. Instead, bottom-up institutional reform, backed by clever political dealmaking, is required to change the dynamics in the sector.

The general point is that the more imperfect the institutions, the more markets will be missing or incomplete, and the less useful price signals will be as a driver of change. Bottom-up mitigation actions, forged in the crucible of domestic political debate, are more likely to ensure institutional commitment to carbon reductions goals and perhaps even promote institutional change than are top-down mitigation commitments.

*Perverse Incentives Created by a Top-Down Approach:
The Climate Policy Uncertainty Principle*

The argument so far has suggested that top-down measures, and the price signals they send, are an incomplete and partial solution to climate mitigation. But when we consider their effect in giving countries incentives to game the climate regime—a climate policy uncertainty principle—top-down caps may be downright pernicious. The only form of caps that guarantee the environmental integrity of the climate regime is an absolute limit on emissions. However, absolute caps for developing countries are not on the negotiating table, at least in the short to medium term. All the other forms of caps under discussion introduce serious incentive problems of various sorts.

For example, proposed reductions from a business-as-usual (BAU) trajectory encourage strategic negotiation about what such a trajectory is likely to look like. Given large variations in economic growth rates over the last few decades, there is little basis for an objective definition of BAU. Given this uncertainty, there is a risk that that BAU will be defined generously in the interests of a political solution, leaving considerable scope for developing countries to generate and industrialized countries to buy offsets, benefiting both groups economically but compromising the environmental integrity of the regime.

Indeed, any approach that requires construction of a counterfactual baseline against which to judge progress risks repeating, at a larger scale, the problems of gaming and high transaction cost that have characterized the Clean Development Mechanism (CDM). Recent efforts to develop sectoral approaches carry the promise of lower transaction costs because any such costs are distributed over potentially much larger gains at the sector rather than the project level. However, even here, discussion has been bogged down over whether a sector baseline should exclude measures that are in a country's national interest anyway, either because they bring other co-benefits or can be achieved at negative cost and therefore should not be eligible for any climate-related incentives or support. In practice, putting any sectoral reforms into various buckets—such as negative cost, co-benefits actions, and positive cost—is a negotiation-intensive and potentially counterproductive task. Framed thus, countries have an incentive to demonstrate that as many actions as possible carry positive costs, and to do so by simply not undertaking actions unless they are linked to climate financing. Thus, many discussions over sectoral approaches carry exactly the wrong incentives—they discourage early action and reward stonewalling and late action.

These are only two among many examples of counterproductive incentives created by aspects of a top-down approach. It is altogether possible that the harm caused by such incentives would outweigh the benefits of a top-down approach, or at least reduce its effectiveness to a level below the effectiveness that could be provided by a bottom-up approach.

Answering the Objections to a Bottom-Up Approach

Is a bottom-up approach based on nationally devised actions really a viable alternative to the various top-down approaches under discussion? The

attractiveness of this approach lies in the potential alignment of interests between development actions and climate mitigation. Why would a developing country not aggressively pursue developmentally useful mitigation actions that yield climate co-benefits, especially if supported by financing from industrialized nations? Without the threat of imminent caps, developing countries are more likely to aggressively pursue such policies. In the medium to long run, a co-benefits approach may not be sufficient, and developing countries, too, may well have to take on more stringent measures to meet the climate challenge. However, in the short run, when early action is at a premium, a bottom-up approach to climate mitigation may well deliver more and earlier mitigation than top-down approaches.

There are three possible objections to this conclusion that should be addressed head on. First, a bottom-up approach leaves little scope to assess whether the sum total of measures is collectively consistent with meeting the climate challenge. However, if measurability and predictability results in less effective action, there is surely a case for rethinking the approach.

Second, rather than sacrificing predictability, perhaps developing countries should be urged to take on absolute reduction caps. However, an effective climate deal cannot come at the expense of a globally legitimate agreement. Moreover, there is little doubt that a climate regime that locks in dramatically unequal per capita emissions across countries, which a set of absolute caps based on current emission levels would do, would be rejected as unfair by much of the developing world.

Third, a bottom-up approach by itself may fail to satisfy political demands by the North that the South make meaningful commitments to limit emissions. However, this argument conflates effectiveness and the use of targets. If, indeed, a bottom-up approach promises larger and earlier actions, then the onus must be on advocates in the North to reshape the nature of political demands in the North, rather than bend the regime in a direction of lower effectiveness to suit political conditions in the North.

In sum, environmental credibility and predictability in developing country actions are undoubtedly to be desired. However, if the quest for predictability comes at the cost of misaligned incentives and a regime that cannot be made consistent with development realities, there may be good reason to open the door to other approaches. Since it avoids both these problems, a bottom-up approach offers, at least in the short run, an alternative and potentially more effective avenue to early mitigation action by the developing world.

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Operationalizing a Bottom-Up Regime *Registering and Crediting NAMAs*

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Key Points

- Nationally appropriate mitigation actions (NAMAs) are one type of mechanism to accelerate developing country participation in GHG emissions reduction efforts.
- NAMAs could be purely voluntary (for inherently financially viable projects), internationally supported (for risky or expensive projects), or capable of producing tradable credits (for projects in between these two categories), the latter categories requiring international consensus.
- NAMAs would run their MRV through a central global registry, with greater levels of regulation for projects that are not purely voluntary, especially for those projects that require significant levels of finance up front.
- Tradable credits would draw the lowest cost emissions reductions and bring in large financial flows, assuming that sufficient demand can be realized from market participants and governments in developed countries.

Although the historical burden of climate change rests with Annex I countries, non-Annex I countries are assisting—in their own ways—with mitigating climate change. However, the current structure of the United Nations Framework Convention on Climate Change (UNFCCC) and Kyoto

Protocol allows these contributions to be neither recognized nor coordinated. South Korea has proposed that Nationally Appropriate Mitigation Actions (NAMAs) undertaken by governments be registered with an international NAMA registry, and for appropriate countries and NAMAs, carbon credit or development assistance might be given.

This paper outlines the South Korean NAMA proposal, and in doing so, it aims to address three major concerns related to such bottom-up approaches, as they are likely to be a component of any future climate agreement. The first concern is that a bottom-up approach will be unable to guarantee sufficient reductions to prevent catastrophic warming. The second concern is that a bottom-up approach will not provide sufficient accountability to ensure that carbon finance funds are used effectively. The third concern is that a bottom-up approach will not be able to guarantee that mitigation measures are undertaken as efficiently as possible. The NAMA proposal contains means of effectively addressing all three concerns.

Nationally Appropriate Mitigation Actions

A NAMA could be any action ranging from economy-wide mitigation targets to a specific project in a specific sector. Examples include sustainable development policies and measures (SD-PAMs), reducing emissions from deforestation and forest degradation (REDD), cap-and-trade schemes, sector-wide technology standards, sectoral targets, a carbon tax, building insulation codes, or congestion targets. Nations would be free to choose to undertake as many or as few NAMAs as they would like.

However, NAMAs would only be eligible for carbon credits or other financial support if they fulfilled certain conditions. Consequently, there would be three types of NAMA. The first would be voluntary NAMAs, or those that require no support and do not qualify for credits. The second would be NAMAs that qualify for international support. The standards for determining whether or not a NAMA would receive financial support could be determined by either bilateral or multilateral agreement. The third would be NAMAs which are eligible for carbon credits. The standards for determining whether or not a NAMA would be eligible for carbon credits would need to be consistent with the standards adopted by other carbon markets to allow for linkage to those markets. In theory, a

project may fall into both the second and third categories, i.e., it may both qualify for support at the outset and be eligible for carbon credits upon completion.

The boundaries between these three types of categories will need to be determined by some form of international consensus or cooperation. In the absence of such cooperation, all NAMAs are voluntary. As a result, this approach provides substantial flexibility to alter the crediting and support standards to achieve policy goals. The most efficient and effective outcome would be achieved by (a) making NAMAs that will pay for themselves voluntary, (b) providing credits but no additional support for those NAMAs that are not cost-effective on their own but would be cost-effective if credited, and (c) providing additional financial support for valuable mitigation actions that are too risky or expensive to pay for themselves through crediting alone. Under this approach, NAMAs that qualify for carbon credits would likely be the primary mechanism for financing mitigation measures in developing countries.

The crediting of NAMAs could be structured similarly to the current structuring of the Clean Development Mechanism (CDM). Credits would be awarded for reductions below efficiency standards or intensity targets. This adds additional flexibility to the NAMA approach, by allowing parties to set different emissions standards for different projects or sectors. Credits would be purchased by Annex I governments and market participants to meet their targets. The result would be a transfer of financial resources from those countries to mitigation actions in developing countries.

For example, the efficiency standard could be set higher or lower based on different priorities. Alternatively, credits could be issued on the program, policy, or sectoral level. For example, it might make sense to award credits on the project level for LDCs with limited net emissions, but only on the sectoral level for major emerging economies where non-sectoral measures are less likely to be effective.

Although the flexibility provided by this approach will yield many benefits, it will also present some challenges. It may take some time to establish politically acceptable intensity targets or methodologies for all the various NAMAs that are likely to be undertaken. Fortunately, many targets and methodologies could be based off of preexisting CDM practices. Also, not all of the details need to be spelled out immediately. Parties may agree on the principle of crediting NAMAs at Copenhagen, while leaving determinations of appropriate standards for later.

MRV and a Global Registry

For NAMAs to qualify for support or credits, they would have to be done in a measurable, reportable, and verifiable (MRV) manner, as defined by Bali Action Plan paragraph 1(b)(ii). MRV standards will act as the link between mitigation efforts in developing countries and financing from developed countries. As a result, NAMAs should be registered in a central registry charged with keeping track of both the total mitigation actions taken by developing countries and the total financing provided by Annex I nations. The registry would function to ensure that any mitigation measures that receive financing or credits do, in fact, result in verifiable emissions reductions, and that all eligible and reported mitigation measures do, in fact, receive financing or credits.

Registration requirements would be different for each of the three different types of NAMAs. Voluntary NAMAs would not need to be registered, but developing countries should have the option of registering them in an MRV manner in order to keep track of their overall mitigation actions. This information would be valuable in providing an accurate account of developing countries' full contribution to global emissions mitigation, as well as helping determine to what extent developing nations are voluntarily taking cost-effective mitigation actions that do not qualify for credits or support.

NAMAs that require support would need to be registered based on an MRV methodology agreed upon by the party or parties providing the support. This could vary substantially on a project-by-project basis, depending on the priorities of the parties involved.

NAMAs that qualify for credits would be subject to a more stringent MRV methodology. This methodology would need to ensure that credits are effectively equivalent to other carbon credits. This is necessary to allow linkage to global carbon markets and to maintain environmental integrity.

Countries would not receive carbon credits until the project was actually completed, but other forms of support could potentially be issued before a project is initiated or completed. However, firms should still be able to receive financing for the project prior to crediting. The participant firm would submit a project idea to a bank to get loans to initiate the project. The firm would later pay back the loans with the revenue generated by the sale of the carbon credits generated by the project. This approach has

already been adopted by many firms initiating unilateral CDM projects, which account for half of all CDM projects.

Although monitoring, reporting, and verification requirements will vary depending on the project, several common features will need to be registered for all projects. Quantity of emissions, support needed and issued, and credits issued should all be registered. Timeframes for project completion could also be registered. Many countries may not have capacity to measure and register their mitigation efforts. Consequently, developing nations should have the option of requesting and receiving assistance to establish the requisite capacity.

The Advantages of Tradable Credits

One of the most important features of this program is the provision of tradable credits. Credits issued for NAMAs would be tradable with firms and nations abroad, similar to CDM, or Emissions Trading System (ETS) on a global scale. This system provides several major advantages over other approaches.

The first is that it allows markets to work to achieve the most efficient reductions. As it is less expensive to reduce CO₂ emissions in developing nations than in developed nations, it is more economically efficient to allow reductions to happen in the least expensive locale. A global trading system is the best mechanism to ensure that capital is most efficiently deployed in these circumstances. According to one model, a global trading system including developing countries could reduce global mitigation costs by 70%.

The second is that a tradable credit scheme will allow for significantly greater overall volume of financial flows and technological transfer than an approach that relies on Official Development Assistance (ODA) or institutional financing. The vast majority of the technology and finance necessary to reduce emissions belongs to the private sector. Consequently, the private sector, not the government, should be the primary source of financial and technological transfer. Furthermore, it will be more politically feasible in Annex I nations to arrange for financial and technology transfers through a trading scheme than through ODA.

For a credit trading scheme to be successful, Annex I will need to ensure that there is sufficient demand for the credits. If the price of credits

is too low or unpredictable, then private investors will not have sufficient incentive to invest sufficient money to ensure a net reduction in emissions. There are two primary ways that Annex I nations can make sure that there is sufficient demand for carbon credits. The first is to adopt more ambitious national emissions targets. By adopting more ambitious targets, Annex I countries will force their market participants to purchase more carbon credits in order to meet their targets, which will in turn increase the demand for credits from developing countries. An alternative approach would be for Annex I governments to purchase the credits directly for retirement.

Although both of these approaches would entail substantial costs, they are preferable to the alternative, which would be to finance projects directly through ODA. These techniques would be both more efficient and more effective than increasing ODA, for the reasons described above. They would also be more politically insulated than decisions about direct assistance. Finally, the MRV registry would enable efficient tracking of total financial transfers from Annex I to developing nations.

Conclusion

Any climate change proposal will fail unless it both receives substantial participation from developing countries and creates strong incentives for private companies to invest in mitigation actions. This proposal will create strong incentives for both groups to vigorously participate in global GHG mitigation efforts.

This proposal also contains the tools necessary to achieve the scale, efficiency, and accountability necessary to address global warming. So long as the price of carbon credits is sufficiently high, developing countries should undertake cost-effective mitigation efforts to receive those credits. If efficiency standards are set wisely, then investments should flow to where they will be most effective. And if a central registry is established, then every significant mitigation action and dollar spent on carbon finance will be accounted for.

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B



Conditionality and Its Governance

Chapter 20



From Coercive Conditionality to
Agreed Conditions

The Only Future for Future Climate Finance

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Key Points

- A prerequisite to a successful global deal on climate change is the closing of the gap between expectations held by developed and developing nations with regard to the quantity and type of climate finance.
- The significant increase in economic and political power in the developing world is leading to the growing influence of recipient countries on the terms of climate finance.
- The traditional model of conditionalities, whether set at the international or national (investor/developed or recipient/developing) level, needs to yield to a new model in which donors and recipients agree on the conditions under which investments are most likely to succeed.
- Under this new model, a growing recognition of the power of developing countries to set policies and priorities for development finance will be accompanied by greater levels of responsibility and accountability for the way in which investments are made.

A global deal on climate change will depend upon closing the gap in expectations between developed and developing countries on climate

finance. Most multilateral environmental agreements (MEAs) provide for the transfer of financial and technical resources from richer countries to poorer countries. These transfers serve the practical purpose of financing developing country capacity to implement projects and policy, and the political purpose of providing incentives for developing country participation in responses to global environmental challenges.

However, financial transfers rarely come without strings attached, i.e., conditionalities imposed by contributor or lending institutions on recipient countries. Conditionalities are thought to be particularly important in the context of global environmental agreements, where scarce financial resources must promote global public goods—such as protecting biodiversity, the ozone layer, and the climate system—that may not be policy priorities for the recipient country. While conditioning access to funds is designed to ensure that the money buys results, it can lead to resentment and a lack of ownership by recipient countries.

In the context of climate change, conditionalities operate in a particularly complex political environment. Climate finance represents, in the eyes of many developing countries and observers, a form of compensation for the damage done to the climate by more than a century of developed country historical emissions, and several decades of continued emissions growth in the context of a growing scientific certainty about the extent of this damage. At the same time, however, the science tells us that even if developed country emissions drop to zero, the growing emissions in the developing world, particularly from emerging economies, will still lead to dangerous climate change.

The climate change negotiations thus raise unique challenges for development assistance. While the South can with some legitimacy demand financial support for reducing emissions, the North and the international community as a whole can legitimately demand a return on this investment. In this context, who gets to set the conditionalities that will, in turn, drive the investments in countries dependent on climate finance?

Broadly, there are three main sources of conditionalities that will determine how climate finance is invested in developing countries:

- Policies agreed multilaterally by the Conference of the Parties to the United Nations Framework Convention on Climate Change (UNFCCC) and any international financial institutions that may be mandated to implement the climate deal

- Policies set unilaterally by national legislation and policies in contributor countries, including mandates on how bilateral assistance will be spent and what kinds of activities will be supported by carbon markets, and/or
- Policies established by the developing country government itself, in the context of national low-emission development strategies and national adaptation plans

Each of these sets of policies emerges from and will shape a dynamic of power, responsibility, and accountability in the relationship between investor contributor governments, investor institutions, and host governments. Ideally, these policies would align, resulting in conditionalities that drive investments that are consistent with nationally determined priorities. In reality, this seems unlikely. Multilaterally agreed policies tend to drift towards a lowest common denominator, as negotiators are required to accommodate the competing concerns of multiple contributors and diverse recipients. Bilateral policies tend to reflect the priorities and interests of the contributor governments, through an exercise of power that favors particular countries, technologies, and policies.

National policies to mitigate emissions and adapt to the impacts of climate change, where they exist, are in the early stages of formation. In developing countries, many of these plans are vague and targeted at an international audience, rather than well grounded in a national consensus. If the latest round of negotiations on climate finance is to succeed in leveraging significant transformations in developing countries, multilateral and bilateral policies will need to support and align with national planning processes. This will require a shift in power from contributor to recipient countries, and a greater sense of responsibility and accountability by recipient countries.

A Brief History of Climate Finance

I will quickly review how the two previous efforts to do a deal on climate finance have distributed power, responsibility, and accountability between contributors and recipients, and then speculate how a new—and better—kind of bargain may be emerging from the Copenhagen process. This summarizes a much longer and more detailed piece of research that the

World Resources Institute is undertaking to both study and inform the negotiations.

The post-2012 climate regime will depend on building upon and agreeing to different terms for climate finance than have been set by the two previous (and largely unfulfilled) climate bargains struck. The first is set out in the UNFCCC, opened for signature at the UN Conference on Environment and Development (UNCED) in Rio in 1992. The Rio Bargain provides, in essence, that the agreed full incremental costs of developing country actions will be financed on a grant basis by developed countries. The bulk of these grants will be transferred through a single financial mechanism, operated by the Global Environment Facility (GEF) under the guidance of the Conference of the Parties to the Convention (COP).

The COP sets the most general of guidance, while operational policies and programs are agreed internationally by the GEF Council. Specific projects are implemented in accordance with the policies of one or more of the GEF's implementing agencies (i.e., the World Bank, the United Nations Development Programme (UNDP), and the United Nations Environment Programme (UNEP)).

Access to GEF funding requires a demonstration that GEF investments represent no more than the "incremental costs" of implementing the Convention and, in doing so, generating a "global environmental benefit" in the form of emissions reductions. In other words, what is funded is by definition that which is not in the national interest. World Bank and UN program officers manage the project cycles and recover their costs through administrative fees. Their environmental and social safeguard standards guide project design and implementation; their financial systems provide for fiduciary accountability. Developing country access to GEF funds is thus mediated conceptually through incremental cost financing, and institutionally through the operations of the intermediary institutions that contributors entrust with designing and overseeing project implementation. This represents a classic contributor-recipient relationship, with conditionalities set and enforced through the exercise of the contributor prerogative. It is not surprising, under these conditions, that GEF projects are often criticized as having little of the catalytic effect necessary to transform national policies and priorities.

The next stage in the development of the climate regime emerged from the negotiations of the 1997 Kyoto Protocol to the UNFCCC, which was

designed to put in place the first internationally agreed upon, legally binding cap on greenhouse gas emissions. Developed countries were required to limit their emissions on average to 5% below 1990 levels between 2008 and 2012. With regard to climate finance, the Kyoto Bargain imported the incremental cost concept, as well as the GEF and its supporting institutions.

But in partial response to the observed shortcomings of the financial flows generated by the GEF, the Kyoto Protocol (KP) parties turned to market mechanisms as an additional source of money, incentives, and conditions. The KP's Clean Development Mechanism (CDM) provides a means for incentivizing investments in emissions reducing projects in developing countries by rewarding investors with carbon offsets for each ton of carbon equivalent of emissions reduced (the CDM also provides a source of grant revenue for adaptation activities in developing countries, by providing that a 2% share of the proceeds from each CDM investment be set aside for this purpose). The CDM's Executive Board sets, at the multilateral level, the conditions under which projects are eligible as CDM investments. The host government must agree to the project, but the investor makes the choice of project and investment. Thus, developing countries could exercise the sovereign power to block a project, but in essence, a new specialized global administrative body, and the private sector, determine whether the project is viable.

Fundamentally, the CDM seeks to commoditize the emissions reduced as measured against a business-as-usual baseline—what the GEF would characterize as the “global environmental benefit”—into a tradable return on the investment. Power shifted from the exercise of the contributor prerogative to the operations of a global administrative body overseeing a private-sector market. Developing countries have been frustrated by the slowness with which the CDM's Executive Board has performed its oversight function, and some of the smaller developing countries have been frustrated by the private sector's pursuit of investment in larger industrialized countries where low-cost offset opportunities are easier to come by. Responsibility and accountability for the performance of CDM projects is largely outsourced to the project sponsors and to private-sector companies under contract to monitor and certify the emissions reductions as they occur. It is hard to find evidence that the CDM is promoting investments or incentivizing policy changes at the mainstream in the countries where it operates.

Towards a Successful Climate Change Deal

A successful climate change agreement will depend heavily on a new kind of bargain on climate finance that catalyzes the kind of transformational change in developing countries that previous deals have failed to deliver. There have been promising signs that the dynamic of power, responsibility, and accountability is shifting.

Developing countries, particularly emerging economies, are more economically and politically powerful than during earlier periods of climate negotiations. The size of their economies and the size of their emissions demand greater recognition. While this may not yield significant new financial flows, particularly in the context of a global economic downturn, it does mean that developing countries are likely to demand and receive more formal power in the operation of any new financial mechanisms.

The CDM's adaptation levy, which is collected without reference to contributor purse strings, has led to the creation of an Adaptation Fund Board (AFB) governed by a majority of developing country representatives. It is possible that negotiators will agree to tap new sources of climate finance de-linked from developed country coffers, for example, levies on international air and maritime bunker fuels, and the international auctioning of emissions allowances. This may lead to a mutually agreed relaxation of the contributor prerogative to set conditionalities.

In the context of the Adaptation Fund, and in discussions around any new financial mechanisms established post-2012, developing countries are also demanding greater responsibility for themselves in the programming of climate finance. Submissions call for "direct access" that would allow recipient countries to bypass the traditional "implementing agencies" by nominating national institutions to receive, program, and account for projects funded under a new climate regime. A number of developing countries have expressed their willingness to demonstrate that national finance ministries or planning ministries can meet international fiduciary standards in order to justify this more directly responsible role.

A re-opening of the incremental cost concept may also be on the table. Inspired by efforts that have been made to calculate the marginal abatement costs of reducing emissions in developing countries, some developed countries have suggested that those projects and policies that can be shown to produce near-term positive rates of return should be imputed to a developing country's business-as-usual baseline. In other words, the next generation of climate finance would assume developing countries

will discover and invest their own resources in those activities that have both domestic and global environmental benefits. Grants and concessional loans would only be available for investment further up the marginal abatement cost curve. Thus far, developing countries have rejected this approach.

The Copenhagen round of negotiations has also produced some movement in the direction of more direct accountability of developing countries for the investments they host, in exchange for greater accountability of contributors for following through on their financial commitments. The negotiators sketched out the essence of this reciprocal relation in 2007. The Bali Action Plan provided—within the same circuitous sentence—that both “nationally appropriate mitigation actions by developing country Parties” and the “technology, financing and capacity-building” to support and enable these actions must be included in a Copenhagen deal in “a measurable, reportable and verifiable manner.”

From Coercive Conditionality to Agreed Conditions

As this book highlights, the costs of a serious response to climate change will likely dwarf the level of development finance available. Moreover, stabilizing the greenhouse gas concentrations in the atmosphere at safe levels will not happen if developing country emissions continue to rise. The dynamics of the negotiations around climate finance have slowly come to recognize this, by searching for new sources of funds, and by beginning to explore ways in which power, responsibility, and accountability for the delivery of climate finance are shared between developed and developing countries.

Coercive conditionalities are profoundly disempowering for developing countries, as they are placed in the position of recipient required to perform against an imposed set of standards. A new and better relationship turns on a recognition that success will depend not on coercive conditionalities, but rather on wise investments that create the right institutional and policy conditions in recipient countries for more sustainable climate-related policies to take root. Direct access to funding for developing countries whose national institutions can demonstrate they meet fiduciary standards, and national systems for measuring, reporting, and verifying funded actions are two new dimensions of a more reciprocal relationship between contributors and recipients that reflect an agreement

on the conditions necessary to empower developing countries to shape their own climate policies.

In other words, the next generation of climate finance needs to focus on the incentives necessary to promote good governance within recipient countries—by strengthening the institutions necessary to perform the functions of responsibility and accountability previously performed by intermediary institutions. There are good signs from early efforts to fund activities to reduce emissions from deforestation and degradation (REDD) that both contributors and recipients are recognizing this essential link between governance and effective climate finance.

Both the World Bank and a consortium of UN agencies (UNDP, UNEP, and the Food and Agriculture Organization) are investing in creating the conditions necessary for forest-rich developing countries to combat the drivers of deforestation. The World Bank's Forest Carbon Partnership Facility and the UN-REDD initiative are both providing grants to help these countries demonstrate their readiness to host large-scale forest offset projects by funding assessments of their institutional capacity. These studies are beginning to reveal gaps in countries' capacity and commitment to make and enforce basic land tenure and land use policies, to recognize and uphold the rights and interests of local forest-dependent people, and to police and discourage international trafficking in illegal forest products. Civil society groups in these countries and internationally are taking note, and they are beginning to see REDD, and this new approach to climate finance, as a means of getting citizens involved directly in assessing their governments' readiness to participate in these new deals.

The involvement of national civil society in the design of climate policy is the only means of ensuring that the relatively weak incentives made available by international climate finance can take hold in a way that transforms economies. This requires a shift in power from contributor to recipient government, and then to ultimate beneficiaries of these flows: the communities and the citizens that will host these investments.

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Getting Climate-Related Conditionality Right

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Key Points

- Climate-related conditionality is an inevitable feature of many future public and private investments in developing countries.
- Climate conditionality raises two basic sets of substantive concerns, one relating to its effectiveness and efficiency, the other to conflicts between climate conditionality and broader development goals and equitable concerns.
- In order to ensure effectiveness and consistency with other objectives, publicly funded investment funds using climate conditions should provide due process to the citizens of recipient countries.

Conditionality has gotten a bad name in development finance. But it may be rehabilitated by the emerging climate change regime. Mitigating climate change by reducing emissions of greenhouse gases (GHGs) from developing countries will require substantial amounts of capital. Some of that capital will come from individuals or organizations who insist that their funds be used in ways that tend to promote mitigation. In other words, they will insist on conditionality. This raises a number of policy

concerns, including several that are reminiscent of debates about conditionality in other contexts.

The first part of this paper provides an overview of existing forms of climate-related conditionality. The second part sets out the main substantive issues involved. The third part considers implications for institutional design and the process by which conditions are formulated.

The Landscape of Climate-Related Conditionality

Climate-related conditionality can take a number of different forms, ranging from obligations for the recipient of funds to reduce emissions from its own activities, to obligations to encourage other actors to reduce emissions, to obligations for recipients to report on their own or others' efforts to mitigate climate change. Many different kinds of organizations have demonstrated interest in imposing conditionality of one sort or another on financial transfers to developing countries or to enterprises or projects located in those countries.

Public Funds Dedicated to Mitigation

A number of large funds sponsored by public actors have been created to channel mitigation-related capital to actors in less-developed countries on concessional terms. These funds are dedicated exclusively to investments in mitigation. Funds created under the auspices of the United Nations Framework Convention on Climate Change (UNFCCC) and the Kyoto Protocol and through other multilateral initiatives include:

- Global Environmental Facility (USD 3.1 billion for 2006–2010)
- United Nations Collaborative Programme on Reducing Emissions from Deforestation and Forest Degradation in Developing Countries (UN-REDD) (USD 35 million)
- World Bank—Forest Carbon Partnership Facility (USD 165 million)
- World Bank—Climate Investment Funds (USD 6.1 billion), made up of the Clean Technology Fund and the Strategic Climate Fund

Additionally, instead of financing specific projects, the World Bank Carbon Finance Unit (CFU) uses money contributed by governments and

companies in Organisation for Economic Co-operation and Development (OECD) countries to purchase project-based GHG emission reductions in developing countries and countries with economies in transition. The reductions are purchased through one of the CFU's carbon funds on behalf of the contributor and within the framework of the Kyoto Protocol's Clean Development Mechanism (CDM) or Joint Implementation (JI) program.

Bilateral initiatives by developed country governments include:

Japan—Cool Earth Partnership (USD 10 billion)

UK—Environmental Transformation Fund (GBP 800 million)

Norway—Climate and Forest Initiative (€ < 600 million)

United Nations Development Programme—Spain MDG Achievement Fund (€90 million)

EC—Global Climate Change Alliance (€100 million)

Germany—International Climate Initiative (€400 million)

Australia—International Forest Carbon Initiative (AUD 200 million)

Other Bodies That Have Adopted Climate-Friendly Standards and Investment Policies

While many organizations that invest in developing countries do not have funds dedicated exclusively to investments in mitigation, they have adopted policies that call for giving priority to climate-friendly investments or at least for avoiding investments that have the opposite effect. Some of these policies are legally binding, others are voluntary.

Publicly sponsored organizations that have taken steps to incorporate climate change concerns into their investment decisions include the International Finance Corporation (IFC), the Multilateral Investment Guarantee Agency (MIGA), and the World Bank, all of which include the reduction of GHG emissions among the priorities they seek to advance in their financing of projects.¹ As a result, these organizations often make financing of projects conditional on the climate-friendliness of those projects.

Several associations of financial intermediaries have adopted voluntary codes of conduct that include commitments to support only climate-friendly projects. One such initiative is the Equator Principles, which have been adopted voluntarily by over 60 project finance institutions. The Principles require participating institutions to observe the IFC Performance

Standards in their lending activities and to provide annual reports on their progress. The IFC's Performance Standards currently require, among other things, clients to report certain GHG emissions and encourage them to employ cost-effective measures to reduce or offset emissions.²

Another example is the Investor Network on Climate Risk (INCR), a network of more than 80 leading institutional investors with collective assets of more than USD 7 trillion. In 2008, INCR announced its Action Plan calling for investors to take nine specific steps to address the growing risks and opportunities from climate change, with a significant focus on reducing GHG emissions. The steps include the following commitments:

- Support clean technology, with a goal of deploying USD 10 billion collectively over the next two years
- Require and validate that investment managers, investment consultants, and advisors report on how they are assessing climate risks in their portfolios, including risks from new carbon-reducing regulations, physical impacts, and competitive risks
- Encourage Wall Street analysts, rating agencies, and investment banks to analyze and report on the potential impacts of foreseeable long-term carbon costs in the range of USD 20 to USD 40 per metric ton of CO₂, particularly on carbon-intensive investments such as new coal-fired power plants, oil shale, tar sands, and coal-to-liquid projects
- Push the SEC to issue guidance leading to full corporate disclosure of climate risks and opportunities

Substantive Considerations

The consequences of adopting any given form of conditionality can be evaluated along a number of dimensions. First, will the conditions be effective? In other words, are the expectations that climate-related conditionality will have a significant effect on the behavior of potential recipients of funding—or other actors—justified? Second, will the resulting reductions of GHG emissions be cost-effective? Third, what impact will climate-related conditionality have on economic development in developing countries? Fourth, will this form of conditionality promote or undermine the equitable distribution of wealth and economic opportunity, either across or within countries? We consider each of these questions in turn.

Effectiveness

The idea that climate-related conditionality will exert a meaningful influence on behavior cannot be presumed. No particular form of conditionality will be effective unless it is adopted by enough investors to cause a meaningful reduction in the amount of capital available without the relevant conditions. A single bank's refusal to finance coal-fired power plants will have little or no effect on overall investment in that type of project.

Accordingly, the most successful conditions, in terms of effectiveness, are likely to be ones attached to funding provided by the multilateral and regional development banks. Those entities remain an important source of funding for many developing countries, especially when it comes to concessional funding targeted at mitigation and adaptation-related projects. Moreover, through the Equator Principles and similar initiatives, the conditions imposed by the development banks also tend to be adopted by large numbers of private actors—a form of cross-conditionality.

Of course, the effectiveness of any given set of conditions depends on whether they are actually enforced. It is not always in the interests of funding organizations to insist upon compliance with climate-related conditions. For instance, managers of profit-oriented funds that have signed on to the Equator Principles may still be tempted to invest in carbon-intensive projects that offer high economic returns. Meanwhile, employees of development banks may experience pressure to fund dirty projects, either from member states or from constituencies within their organization who have an interest in maximizing the volume of lending.

Effectiveness is a question that would benefit from empirical research. It would be useful to know, for example, whether organizations that have the right to insist on compliance with climate-related conditions either ignore instances of non-compliance or waive the right to insist on compliance. If organizations do relax their compliance or enforcement standards, it would be helpful to know when and why they do so.

Cost-Effective Emission Reduction

To the extent that climate-related conditionality is an effective method of altering the behavior of the recipients of funding or other actors, the next question is whether the result is a cost-effective reduction of GHG emissions. There are several reasons why this outcome cannot be presumed. First, some funds may employ social or economic conditions—

including sectoral or geographic limitations—that go beyond requiring emission reductions and preclude investment in projects associated with relatively cost-effective reductions in GHG emissions. Second, when a number of projects satisfy the conditions of a given fund, it may, either advertently or inadvertently, fail to give priority to the projects that offer the greatest reduction in GHG emissions per unit of capital invested.

One way to address these concerns is for funding organizations to review their conditions regularly to ensure that they are promoting cost-effective emission reductions. A more fundamental response would be to abandon funding conditionality altogether and rely on economic actors to identify cost-effective mitigation opportunities using the price signals generated by, say, a cap-and-trade or credit trading system.

An additional consideration is that conditionality entails certain transaction costs—the costs that both providers and recipients of capital bear in monitoring, reporting, and verifying compliance with any given set of conditions. Those costs can be particularly significant for developing countries with limited institutional capacity. Transaction costs may also be particularly high when recipients have to comply with several distinct sets of climate-related conditions. If the benefits of conditionality were outweighed by the related transaction costs, this would weigh in favor of abandoning conditionality (although the transaction costs associated with alternatives may not be trivial). One strategy for limiting the costs of conditionality is to enhance consistency across the climate-related conditions imposed by various financial institutions, both public and private. This could be accomplished through explicit harmonization, incorporation by reference to international standards developed through the Copenhagen process, or forms of cross-conditionality where one organization adopts another's standards.

Host-Country Development

Allocating capital in a fashion that efficiently reduces GHG emissions is not necessarily consistent with maximizing benefits to society along other dimensions. In the absence of regulation, the most climate-friendly projects are usually not the ones that generate the largest pecuniary returns for investors. Likewise, climate-friendly projects will not necessarily generate the greatest amounts of employment, the most helpful forms of technology transfer, or the most effective forms of adaptation to climate

change. This raises the potential for conflicts between the interests of actors concerned primarily with climate change mitigation and the interests of inhabitants of developing countries.

This issue is coming to a head in the debate over whether the multilateral development banks and other financial institutions should finance coal-fired power plants. The World Bank has a goal of having 50% of its energy portfolio dedicated to low-carbon investment (which includes clean coal with several conditions attached). If enforced, this policy will reduce the supply of capital for new coal-fired power plants to some extent. Is this in the best interests of countries that desperately need cheap energy to sustain their economic development? These concerns are particularly pressing for the Least Developed Countries, which desperately need growth and are only minimally responsible for past and present GHG emissions, and yet are also most vulnerable to the negative consequences of global warming.

Equity

The benefits of GHG emissions reductions will be distributed globally, though not necessarily uniformly. Meanwhile, to the extent that individual projects create jobs, transfer technology, or support adaptation to climate change, the costs and benefits are likely to be concentrated in the projects' host countries, and even among particular segments of society. Conditions that preclude financing for coal-fired power plants are one example: they may provide global benefits at the expense of the inhabitants of developing countries. As another example, conditions that promote investments in REDD may produce globally diffused benefits in the form of climate change mitigation and locally concentrated benefits for governments or private landowners who receive cash transfers to encourage forest conservation. But these conditions may simultaneously impose substantial costs on indigenous groups prevented from using forests in traditional ways.

Another important issue is whether it is appropriate to impose conditions that are inconsistent with the distribution of mitigation-related costs agreed to by states in international negotiations. In other words, is Copenhagen-plus conditionality acceptable? This question is likely to be a particularly pressing one for the multilateral development banks, whose conditionality arguably should not deviate significantly from international law.

Implications for the Process of Implementing Conditionality

The processes by which conditions are formulated and enforced also raise some extremely important concerns. Due process in conditionality—in the colloquial rather than the legal sense—is intrinsically worthwhile, and may also, to the extent that it enhances legitimacy, tend to induce both providers and recipients of capital to adopt and comply with conditions. As we have already argued, widespread adoption and compliance is important if conditionality is to be effective and implemented with minimal transaction costs.

In the context of climate-related conditionality, the central procedural questions revolve around the roles that different parties, especially the inhabitants of recipient countries, ought to play in formulating conditions. These questions are particularly important for conditionality imposed by publicly sponsored actors. It seems intuitive that local constituencies affected by the decision of a public actor ought to be entitled to benefit from well-designed accountability, transparency, and participation mechanisms. In other words, to the extent that a fund's investment decisions affect the level or distribution of wealth in a society, it ought to be accountable to members of that society who in turn ought to be able to participate in those decisions, observe the processes by which they are made, and hold the decision-makers accountable.

The difficulty, however, with granting procedural entitlements to actors from recipient countries is that they may favor different substantive outcomes than providers of capital. For instance, they may prefer projects that generate local employment to projects that efficiently reduce emissions. Or they may prefer projects that support adaptation over those that support mitigation. Consequently, granting local actors robust procedural entitlements risks alienating financiers with opposing preferences. Generating this kind of local ownership of the process of formulating and enforcing conditions, without undermining other objectives, is one of the central challenges associated with all forms of conditionality.

Conclusion

Climate-related conditionality in development finance is probably inescapable. The challenge going forward will be to fashion conditions that balance potentially competing interests in effectiveness, cost-effective

emissions reductions, development, and equity. Formulating institutions and processes capable of resolving these issues in a legitimate fashion ought to be a central concern in designing a global regime to address climate change.

FURTHER READING

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NOTES

1. See IFC, “Performance Standards on Social and Environmental Sustainability,” Standard 3, [http://www.ifc.org/ifcext/sustainability.nsf/AttachmentsByTitle/pol_PerformanceStandards2006_full/\\$FILE/IFC+Performance+Standards.pdf](http://www.ifc.org/ifcext/sustainability.nsf/AttachmentsByTitle/pol_PerformanceStandards2006_full/$FILE/IFC+Performance+Standards.pdf); and World Bank Group, “Environmental, Health, and Safety Guidelines” (known as the “EHS Guidelines”), section 1.1, “Air Emissions and Ambient Air Quality,” [http://www.ifc.org/ifcext/sustainability.nsf/AttachmentsByTitle/gui_EHSGuidelines2007_GeneralEHS/\\$FILE/Final+-+General+EHS+Guidelines.pdf](http://www.ifc.org/ifcext/sustainability.nsf/AttachmentsByTitle/gui_EHSGuidelines2007_GeneralEHS/$FILE/Final+-+General+EHS+Guidelines.pdf).

2. IFC, “Performance Standards on Social and Environmental Sustainability,” Standard 3(11).

Chapter 22



Making Climate Financing Work

What Might Climate Change Experts Learn from the Experience of Development Assistance?

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Key Points

- Financing for climate change mitigation will likely involve some form of conditionality, although conditionality alone is a poor guarantor of project or policy success.
- The most important factors in determining project or policy success is the alignment of a project with the priorities of the community and local ownership, local implementation, and the timing, certainty, and reoccurrence of funding.

At the heart of any global deal on climate change lies a compact between wealthy and less wealthy countries. The vast majority of industrialized countries have already accepted binding commitments to reduce their greenhouse gas (GHG) emissions (although few have made any progress to reducing emissions in practice). Future progress in limiting emissions relies upon wealthy countries meeting their commitments and—equally importantly—upon major emerging economies agreeing to accept limits on their future emissions. No such deal has yet been forged. At the same time industrialized countries and emerging economies have agreed that support must be offered to poorer developing countries that will be

severely affected by the failure (to date) to mitigate emissions. Most proposals envisage that wealthy countries will persuade developing countries by putting financing on the table. But how, and with what strings or performance criteria attached?

Climate change experts have framed the problem as one of how to best use finance to incentivize developing countries to undertake significant near-term mitigation measures and eventually transition to emissions caps. The assumption is that by setting up incentives for developing countries to deliver, the industrialized countries will be able to transform policies and practices in developing countries. Wealthy countries will set goals and disburse financing only upon proven performance of actions taken towards the goals.

A long history of donor efforts to incentivize policymakers in developing countries could usefully inform climate change proposals. Donors often believe that the use of structured incentives and conditionality are sufficient to ensure that countries will adopt particular policies or meet certain objectives. Although this is intuitively appealing, the history of attempts to do this suggests that this is a fundamentally mistaken view. In fact, the main impact of such structured incentives or conditionality may well lie in the effect on the behavior of those providing the financing.

Reliance on incentives and performance-based conditions offers a tempting shortcut, which often leads donors away from examining other elements that are significantly more likely to shape whether or not a government or local authority will achieve particular goals. Let me outline some of these elements.

1. Alignment and Ownership (and How to Test for It)

A core lesson from development assistance is the importance of aligning any foreign-supported proposed policy or project with a country or a community's own priorities and objectives. This lesson has been accepted by major industrialized country donors in the 2005 Paris Declaration on Aid Effectiveness and the subsequent 2008 Accra Agenda for Action. The lesson is also often expressed in terms of ownership: the more a policy or project is owned by those who implement it, and the more closely a project or policy reflects local priorities, the more likely it is to succeed. This goal is easy to state but difficult to translate into operational guidelines. How does one test whether or not a project or policy is locally owned or

sufficiently aligned and what does that mean? Important indicators of local ownership could include

- the origination of the project or policy (who had the idea?);
- the design of the project or policy; and
- the financing and resourcing of the project or policy (have locals contributed resources?).

The latter is perhaps the clearest indicator of how much priority a community gives to the idea proposed.

All that said, any tests of ownership require an initial answer to the question “owned by whom?” Is it ownership by a government that matters, or by an individual Minister within the government, or by a disenfranchised minority? Here providers of external financing have to make explicitly political choices about whose visions and aspirations they are supporting within a society. No policy will succeed without local champions—no matter how much this fact might be obscured by the design of performance-based or incentivizing systems. The political choices involved are difficult and complex.

It is even more difficult in practice for donors to support rather than overwhelm local champions. This takes me to a second condition for success.

2. Local Implementation (and Resisting the Temptation to Micro-Manage)

Implementation must always rely upon local actors and institutions. The experience of aid demonstrates how tempting it is for external funders—who have identified local champions—immediately to use them as a leverage point to try to shape ever wider and deeper areas of policy. For example, some donors who established an initial relationship with communities by helping governments to phase out user-fees for education, have then tried to use these openings to push for other kinds of reform (such as public-private structures) in the education sector. To quote one aid official participating in an Oxford workshop on aid negotiation and management: “it’s just really hard for us not to get in there and try to shape everything.”

What begins as external support for a local initiative can quickly be-

come a circumvention of local expertise and institutions. This may result in an erosion of local governance, accountability, and the likelihood of success. To prevent such consequences, donors should seek to ensure clarity among themselves and holding one another to account in defining (and limiting) their goals and subsequent influence over implementation.

3. The Timing of Financing

Often the timeline of development disbursement is determined by the donor, which results in aid being delivered either too fast or too slowly. Disbursement pressures to deliver too fast exist where an agency has an annual cycle of lending and its officials need to ensure that they lend out all that is available. By contrast, many agencies deliver aid too slowly where risk-aversion in the bureaucracy and overall risk-minimizing decisionmaking structures result in bureaucratic delays in disbursement. In either case, the timing of financing will greatly limit the likelihood of project or policy or policy-reform success.

4. The Certainty and Recurrence of Funding

Many of the policies and projects aimed at addressing climate change require long-term planning and investments. If governments are to consider external financing in planning for the future and in investing in infrastructure or personnel, the financing must be both certain and recurrent. Yet often aid is both volatile and unpredictable. Performance-based conditions and targets (some of which may not be reached due to exogenous shocks beyond the control of a government—such as a drought, or a global financial crisis) are likely to make projections of aid receipts yet more uncertain. Aid-dependent governments work within very tight constraints. Their spending plans are typically developed within parameters set by the IMF and World Bank. The multilaterals analyze the sources of the government's revenue and its capacity to service debt in the future. These debt sustainability analyses were created to ensure that efforts by governments to meet the Millennium Development Goals do not build up unsustainable levels of future debt. Such a debt build-up would be the result of governments spending money which donors had promised but did not disburse.

5. *Reporting Structures and Local Accountability*

Providers of external finance usually require direct reporting back to them in forms that fit their own exigencies. For example, each donor government often has its own accounting format that it must use to report to its own auditor-general or parliament. As a result of this, donors require developing country governments to use numerous different formats for reporting. The devastating results have been documented in a study commissioned by donors concerned with this problem. Reporting in this way maximizes the burden on developing countries and does not support efforts within developing country governments to simplify, streamline, and make more transparent their own finances. For these reasons, the reporting structure of external financing is likely to affect the long-term sustainability and accountability of policies or projects.

6. *The Adaption and Renewal of Externally Funded Projects or Policies*

Finally, projects and policies need constant ongoing adaptation and re-design, as well as formal evaluation and renewal. Part of ownership of a project or policy is ownership of the processes of review, adaptation, and renewal. All too often in development assistance, these processes are conducted by the external funding agency rather than by (or with) the local champions and implementers. The result is a system of reporting and evaluation that is unlikely to bring to light problems which need resolving or redesigning around. Donor-designed adaptation and renewal are also unlikely to strengthen local governance and policymaking capacity.

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