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SEVENTH FRAMEWORK PROGRAMME

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[POLICY BRIEF]

International Public Finance to Address Climate Change in Indonesia – Lessons for the Future of European Development Cooperation

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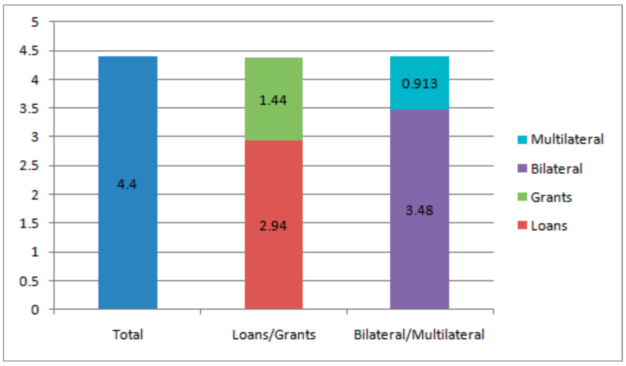
International finance for climate change has become an important barometer for how rich countries with high historical emissions will help developing countries shift away from carbon-intensive development to lower carbon development pathways. The 2010 Cancun Agreements state that developed countries should provide new and additional resources for developing countries approaching $30 billion for the period 2010 to 2012 and that longer-term funding should come from both public and private sources to mobilise $100 billion per year by 2020. Much of this conversation has stayed at the level of demanding transparency in pledges and commitments from contributor countries to address climate change in developing countries, and ensuring that governments adhere to the United Nations Framework Convention on Climate Change (UNFCCC) principle of ›responsibility‹ and ›capability‹ to pay.

But what is often missing from the international debate is evidence of what is happening ›on the ground‹ as international pledges are increased. Is finance actually reaching climate change mitigation and adaptation activities? How is it being delivered? Are lessons from the aid effectiveness debate being considered? And what can we learn for the future? These are important questions for European donors, especially given European fast start funding (FSF) pledges at Cancun and a new Green paper on the future of budget support that covers quality, value for money and impact of budget support[1]. This brief presents four insights on climate change mitigation finance in Indonesia[2].

Current and future international public mitigation finance flows in Indonesia

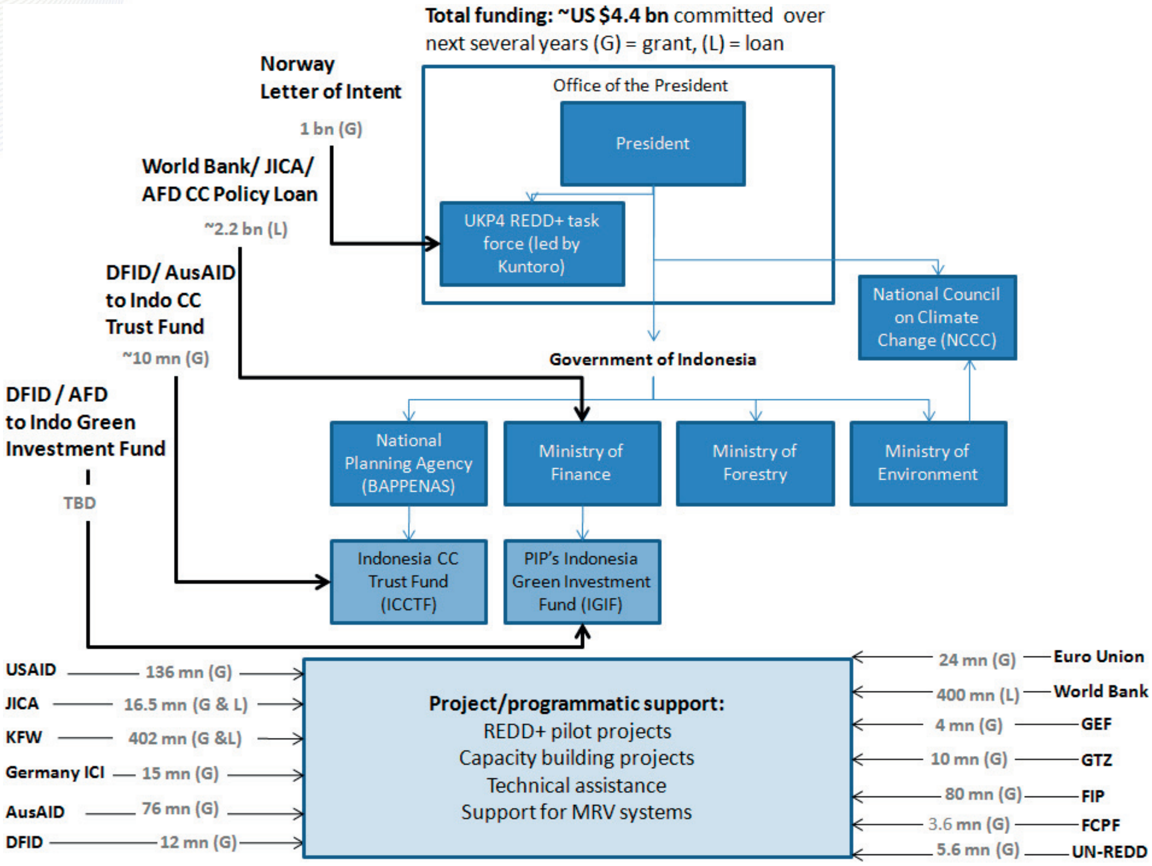
Committed and secured international financial support for climate change mitigation in Indonesia is approximately US$ 4.4[3] billion over the next few years, with EU donors contributing roughly 30 % of total support. This roughly breaks down as US$ 2.94 billion in concessional loans, and US$ 1.44 billion in grants and technical assistance; US$ 3.48 billion in bilateral assistance and US$ 913 million in multilateral assistance (figure 1 and 2).

Figure 1: current international public mitigation finance to Indonesia



This has led to a large number of active donors (figure 2), funding instruments (table 1), and activities aimed at mitigating climate change, particularly in support for Reducing Emissions from Deforestation and Degradation (REDD+iv) and renewable energy and energy efficiency projects. Several additional pledges are in the pipeline, and could provide an additional several billion dollars. Based on insights from donors, this trend looks set to continue over at least the next 5 years.

Figure 2: National landscape of international public finance in Indonesia



Source: Author[5]

Table 1: Donor-supported funding instruments for climate change mitigation in Indonesia

Instrument	Description
The Climate Change Policy Loan (CCPL)	A loan, often with a low interest rate and extended payment terms, provided to develop a lower carbon, more climate-resilient growth path. Directly incorporated into the country's general budget to cover fiscal deficit.
The Indonesia Climate Change Trust Fund (ICCTF)	National trust fund owned and managed by the government of Indonesia. Provides grant funding to ministries for climate change activities. Aims to reduce transaction costs by cutting the number of free-standing projects, and by harmonizing the financing into a ›basket fund‹.
Indonesia Green Investment Fund (IGIF)	A ›special purpose vehicle‹ under the Ministry of Finance's Government Investment Unit, aimed at leveraging private and market-based sources of funding for private sector low emissions development projects.
The Norway-Indonesia ›Letter of Intent‹ (LoI)	A bilateral agreement between Norway and Indonesia intended to finance REDD-plus activities, aimed at reducing deforestation to curb emissions, at the national level. Majority of funding is conditional on ›performance based‹ verifiable emissions reductions.
Bilateral and Multilateral Project Support	Support for specific projects and programmes, through technical assistance, capacity building, REDD+ demonstration projects, support for measuring, verification and reporting systems etc.

This has led to a large number of active donors (figure 2), funding instruments (table 1), and activities aimed at mitigating climate change, particularly in support for Reducing Emissions from Deforestation and Degradation (REDD+[4]) and renewable energy and energy efficiency projects. Several additional pledges are in the pipeline, and could provide an additional several billion dollars. Based on insights from donors, this trend looks set to continue over at least the next 5 years.

The following table demonstrates that international donors are supporting several different instruments and delivery channels to address climate mitigation in Indonesia at the national level.

Climate finance and its aid effectiveness implications

The increase in activity on climate change has been accompanied by challenges in terms of coordination[6] and alignment[7] of finance. Coordination challenges arise between donors, between donors and government, and within government, and alignment challenges arise between donor and government systems. For example, the CCPL allows for finance to be disbursed directly to the government's treasury, and uses the government's own allocation systems, thus it is strongly in ›alignment‹. This allows the government to have complete control over the allocation of the resources according to the programmes and activities they prioritise. Other modalities use parallel systems to those established by the government; much of the externally funded sub-national projects are effectively working outside the government systems. From a climate mitigation perspective there are still challenges in both approaches, but from an aid effectiveness perspective, the fact that much donor finance is still ›sealed off‹ from normal government activity may be a concern for the long term effectiveness of the finance to support sustained responses to climate change.

There appear to be two main reasons for the lack of coordination and alignment:

1. **Different donor priorities and financing approaches:** While a few donors are strongly rooted in their support of the Paris Principles on Aid Effectiveness and are working through national institutions and procurement processes, many donors chart a course outside the government's institutional framework in order to maintain control and accountability over resources, and as a way to avoid dealing with national and local systems that are often regarded as slow and ineffective. The restrictions of existing financing modalities (e.g. in terms of procurement guidelines; funding cycles) exacerbate this challenge.
2. A poor understanding (among donors and within government) of what activities need to be supported and the appropriate financial modalities to address these needs: This has led to a lot of ›business as usual‹ support, for example involving a large number of workshops and capacity building activities, that only indirectly target abatement needs. While national economic needs assessments have been carried out, the assessments are often too general or broad to give accurate cost projections for different sectors. Some of the methodologies used also have severe limitations. In order to build more effective responses, it will be important to better understand these needs and to build financing modalities accordingly.

There are efforts by both government and donors to coordinate the different funds and activities and ensure they align with country systems. A number of different working groups have been set up to coordinate different parts of the climate change response and various activities are underway to better understand the current landscape.

Does climate finance present new challenges for donors?

While climate change finance presents challenges that are common to the aid effectiveness debate, there are differences that may give rise to some less familiar challenges.

1. There is a strong emphasis on the need to ›measure, report and verify‹ (MRV) all mitigation action, and on ›pay for performance‹ in terms of emissions reductions by both developed and developing countries in a post-2012 agreement (Breidenich & Bodansky, 2009)
2. The importance placed on achieving financial ›additionality‹ for climate change at the international level (Brown, Bird, Schalatek, 2010) could be creating incentives to use less aligned financing initiatives, which can provide higher visibility of support.
3. There is a need to achieve immediate results to avoid carbon lock-in. The recent emphasis on ›fast start finance‹ highlights the need to augment international public flows to support climate change between 2010 and 2012, and is largely focused on achieving immediate and demonstrable results.

Indonesia is one of few countries in which public finance is likely to be delivered at scale in a ›pay for performance‹ modality through the Norway-Indonesia LOI, which has some similarities to a market based mechanism in which tonnes of emissions reductions achieved are the unit of trade. Significant attention is being placed on building an MRV system and this is accompanied by a set of policy measures that aim to reduce deforestation, developed through a multi-stakeholder process. The question was raised by a number of interviewees as to the extent that these (and other REDD+) processes are driven by the government's own priorities and whether the conditions imposed by international climate change policies, will have the desired effect on emissions reduction. While it is impossible to determine the impacts of the emerging system, the changing basis of the donor-recipient relationship highlights that it would be useful to re-visit lessons from debates about aid conditionality (e.g. the ability to induce policy reform) as such policies are developed.

Some interviewees suggested that the obsessive focus on achieving large scale finance may be the wrong emphasis for a country like Indonesia, which may not require huge resource flows but rather reform of national fiscal policy and incentives which require little financing. The focus on scale certainly acts as an important entry point for discussion between countries, but given Indonesia's low level of ODA flows relative to GDP, it is unlikely that it could ever be significantly scaled up to have sufficient incentive effects on mitigation actions. Instead, it was suggested that smaller levels of finance could be used more strategically, either politically or to leverage private finance in some areas.

Conclusions and recommendations for future EU climate financing

International public finance flows to support climate change responses in emerging economies such as Indonesia are likely to increase at least over the next 5–10 years. Undoubtedly challenges will arise from both aid effectiveness and climate change mitigation perspectives, in the delivery of this finance. In a recent policy announcement at Cancun, the EU committed to further FSF. At the same time, the evolution of the EU development agenda emphasises areas such as ›value for money‹ and ›the role of conditionality and links to results‹, driven in part by the global economic crisis. The current situation in Indonesia provides some initial lessons for meeting these dual objectives, and moving towards more effective climate financing. These include the need to:

- better understand what climate change mitigation activities need to be funded within countries and to build financing modalities that meet these needs, rather than to be guided by which modalities are available;
- move beyond the question of scale of finance as an indicator of effectiveness, especially in emerging economies in which public international climate finance flows are likely to remain small compared to national budgets;
- move donor coordination beyond information sharing, towards more combined strategies and joint coordination with government;
- increase flexibility among donors in the way they deliver finance (e.g. in terms of procurement rules); and
- to better consider lessons from earlier development cooperation debates in the development of new conditional financing modalities such as REDD+.

1 http://ec.europa.eu/development/icenter/repository/green_paper_budget_support_third_countries_en.pdf

2 Summarised from the EDC2020 Working Paper: Climate Finance in Indonesia: Lessons for the Future of Public Finance for Climate Change Mitigation by Jessica Brown and Leo Peskett, 2011. The research findings are based on in-depth country research and extensive donor and government interviews.

3 While this figure includes a few regional projects by the EU, the vast majority of support is targeted at Indonesia specifically.

4 REDD+ uses financial incentives to reduce the emission of greenhouse gases from deforestation, forest degradation, restoration, rehabilitation, sustainable management and af/reforestation.

5 Note: the arrows indicate the flow of finance from donor to recipient agency and/or project. For direct project/programmatic support, this often involves a range of different implementing agencies. November 2010 average exchange rates have been used (www.oanda.com).

6 Coordination refers to *any institutional interface between a set of donors and partner recipient organizations as well as the mechanisms within these donor and partner organizations that aim to streamline the aid process* (McCormick et al., 2007).

7 Alignment refers to the need to align donor support with the partner country objectives and strategies, and to use strengthened country systems. Within the Paris Declaration, donors have committed to ›base their overall support – country strategies, policy dialogues, and development cooperation programmes – on partners' national development strategies‹. Additionally, donors have committed to ›use country systems and procedures to the maximum extent possible... avoid, to the maximum extent possible, creating dedicated structures for day-to-day management and implementation of aid-financed projects and programmes‹ (CABRI, 2008).

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