Centre for Climate Change Economics and Policy

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# Understanding climate finance for the Paris summit in December 2015 in the context of financing for sustainable development for the Addis Ababa conference in July 2015


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## Policy paper

**March 2015**


**ESRC Centre for Climate Change Economics and Policy**

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**Understanding Climate Finance for the Paris Summit in December 2015 in the Context of Financing for Sustainable Development for the Addis Ababa Conference in July 2015**[1]

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## Part 1: Principles and questions

*(A) Context/principles*

1. The third International Conference on Financing for Development will be held in Addis Ababa, Ethiopia, from 13 to 16 July 2015, and takes place before the 21st session of the Conference of Parties (COP21) to the United Nations Framework Convention on Climate Change (UNFCCC) to be held in Paris, France, between 30 November and 11 December 2015, which will include discussions about climate finance. The agreement on the Millennium Development Goals (MDGs) following the United Nations summit in 2000, and on finance at the first International Conference on Financing for Development in Monterrey, Mexico, in 2002, preceded any really effective climate finance discussions. However, there is clear and strong recognition in the Sustainable Development Goals (SDGs), which are under preparation for the United Nations General Assembly in September 2015 in New York, of the importance of sustainability. Indeed the word “sustainable” appears in 11 of the 17 draft goals. In addition, the word “resilient” is used in connection with infrastructure and cities. Further, goal 13 (without the word sustainable) states explicitly “take urgent action to combat climate change and its impacts”. Thus negotiations about climate finance in Paris must be defined in the context of a very clear embodiment of climate and sustainability in the SDGs.

2. The SDGs build on the MDGs, but, first, add great emphasis on sustainability, and, second, greatly strengthen the level of ambition on poverty reduction in all its dimensions. They take the fight against poverty into broader and deeper areas such as: ending poverty *everywhere*, *lifelong* learning, health *at all ages*, and so on.

3. The challenges of development, growth, poverty reduction and sustainability are deeply and intricately interwoven with those of mitigation of and adaptation to climate change. It would be deeply damaging to try to treat them as separate entities for action and for finance. ‘Defining Paris relative to Addis’ must take this carefully into account. The different organisational tracks for the conference in Addis Ababa and the summit in Paris should be seen as an opportunity to complement and reinforce, not as a recipe for separation. Indeed, radical separation of finance for development and climate finance could be deeply damaging. It is a serious mistake to see action on climate and action on development as in conflict, or action on the former as a ‘plot’ to slow the latter.

4. The overall figure of US$100 billion per annum by 2020 for climate finance is found in the Copenhagen Accord from COP15, which took place in Copenhagen, Denmark, in 2009, and embodied in the decisions of COP16 in Cancún, Mexico, in 2010. It is

[1] This note has benefited greatly from input and interactions with Amar Bhattacharya (Brookings) and Jeremy Oppenheim (McKinsey) with whom I am collaborating on broad questions of development and climate finance. I am also grateful for the comments of Rodney Boyd and Emmanuel Guerin.

now a political commitment and has to be embodied in, and interpreted as such, for Paris in 2015.

*(B )Questions for Climate Finance*

1. How should climate action, and finance for that action, be designed around SDG strategies and finance, in order to foster the strongest "climate boost" relative to other SDG actions/finance, whilst, at the same time, enhancing development effects?

2. What meanings can be attached to "additionality" of climate finance relative to development finance?

3. How large should the Paris climate finance objectives be? How much public and private?

4. How should flows of different kinds be counted, in particular towards the US$100bn that has been committed to dedicated climate finance?

These questions are clearly inter-related and all are relevant for the Paris discussions.

**Part 2: Some answers**

*The scale/ambition of, areas of, and nature of, SDG activities* will all influence the answers to these questions. As noted, climate goals are now fully embedded in the SDGs, as they should be, given the inter-relations between actions on development and climate. The ambition for development and climate outcomes embodied in the SDGs has implications for the scale of financing requirements from all sources. There are relatively limited 'free-standing' climate actions (with their associated financing requirements) in the sense of actions which are motivated only by 'climate' and not by 'development'. The bulk of the financing requirements are embedded in financing needs for low-carbon infrastructure and non-infrastructure activities. At present, other than China and a few other exceptions, the world is under-investing in infrastructure, especially in developing countries where there are the largest unmet needs. And much of the investment that is taking place is neither low-carbon nor climate resilient. We should also recognise that, at least in some areas, the investment that is seen as low cost, in current market conditions and without appropriate pricing for externalities, is high-carbon-intensive and, similarly, that low-carbon-intensive investment can be seen as high cost (not taking into account ancillary benefits that often accrue nationally). In this sense, the greater the investment of this type, the greater the opportunity and need for complementary finance for low-carbon. We should note also that some important activities for development would have less scope for complementary climate finances, for example education.

*Question 1*

A key emphasis and driving concept is how to find climate actions and finance (Paris) which give powerful climate contributions or boosts in the context of SDG finance decisions (Addis). There is, and should be, substantial logical and practical simultaneity in these decisions, but it helps to think of the climate decisions in the context of the SDG decisions.

The climate actions and their finance should be designed to *complement* (take advantage of and intensify) the climate aspects of the development decisions. And they should be designed to be *additional*, in some sense (see next section). It is well-designed complementarity and additionality which can combine to give a powerful climate boost from decisions at the Paris summit in relation to the conference in Addis Ababa.

*Question 2*

Additionality of climate finance can be understood in four ways. In all four we should recognise the close links between actions on climate, poverty reduction and development.

(i) *Programmes or projects* that would not have come about without the climate finance. This is a standard use of the term additionality in development banks, e.g., EBRD. Examples could be programmes to protect tropical rain forests or to build sea-walls to protect against climate-related storm surges would fall into this category.

(ii) The finance stimulates action in *areas* which would not otherwise be covered or financed adequately. In particular the role of targeted climate finance is to ensure that the trillions of dollars of investment in infrastructure and non-infrastructure activities are as well-designed, efficient and low-carbon as they can be in a carbon-constrained world. In this, the additionality comes from stimulating the right policy choices to foster such investment and through helping to put together viable overall financing packages in order to improve the financial risk-return performance of low-carbon versus high-carbon investments, and bring market returns closer into line with economic returns.

(iii) Mobilising new *sources of financing* that would not otherwise have been forthcoming or available, such as a slice of carbon tax revenue, flows via the Clean Development Mechanism, and new climate-dedicated expansions of multilateral development banks (MDBs). This was the approach adopted in the work of the United Nations Secretary-General's High-Level Advisory Group on Climate Financing, which reported in 2010.

(iv) A *scale* of overall Official Development Assistance (ODA) resources for climate action which is additional to what has been previously committed to development. There are important ethical and economic arguments that indicate that a stronger understanding of the actions necessary to mitigate and adapt to climate change should make rich countries more ready to provide additional concessional finance. However, (see next section) it is inherently difficult to assess such additionality against a benchmark of what has been committed for development.

There is some overlap between (i) and (ii), but (i) highlights projects in given sectors or areas which would not otherwise come about, and (ii) focuses on low-carbon strategies that would be otherwise under-emphasised and not adequately financed.

The last of the four is very hard to nail down because development and climate actions are so intertwined in many areas, and because it is so hard to answer the question "what total resources would have been made available under ODA in some year (say, 2025) if we had never heard of climate change?" We can probably say that the readiness to provide ODA will have been increased with the recognition of climate change as a problem because (a) development has become more difficult and (b) the donor gains from climate action in another country. But how much such an increase might be is extremely difficult to understand or measure. Some have argued that the ODA committed for climate must be additional to the 0.7 percent target of GNI of rich countries that had been previously committed at Monterrey in 2002. But how to assess this is problematic given that the 0.7 percent is not binding and has not been realised for most donor countries. Understanding of additionality in terms of (i) (ii) and (iii) seems to be more fruitful than (iv). Indeed, the fourth route is likely to generate confused and unproductive discussions. However, it is important to continue to stress the importance of adequate levels of ODA and concessional climate finance, and the moral case for intensifying development and climate assistance in the face of the great challenges posed by the threats of climate change.

Hence there are the following propositions for areas of climate finance and action.

(1) Promoting low- or lower-carbon activity in relation to infrastructure that may be under-emphasised in the agreement in Addis Ababa. That would include, in particular, lowering the cost of capital (important for scale, and for renewables and public transport, both of which are relatively capital intensive). This would play an important role in helping 'affordability' (both for scale of action and for poorer people) in the context of major investment programmes. Additional climate finance is particularly important for the poorest countries where affordability and access to capital markets is a major issue, but will be relevant for some middle-income countries too since the bulk of overall mitigation efforts must be there (this is where the big carbon-intensive investments would be without action to move towards low-carbon).

(2) Promoting low-carbon activities, including energy efficiency, in non-infrastructure activities for buildings, transport, industry, agriculture, etc.

(3) Adaptation, particularly for the most vulnerable and poorest countries.

(4) Avoiding deforestation, more productive land use, and protection of fragile resources, including oceans and biodiversity.

(5) Innovation and breaking new ground for climate action, including novel ways for the public and private sectors to work together (e.g. carbon capture and storage or climate-resilient agriculture). Recall the 'green revolution' for wheat and rice in the 1970s where much of the action was in local agricultural research and extension. Innovation should be cross-cutting and everywhere, but a direct focus would also be very valuable given how critical it is and the need for fitting into country contexts.

(6) Regional action: many climate actions for both adaptation and mitigation are regional in nature but at the moment are under-supported and under-funded.

(3), (4) and (5) represent programmes that would not come about without targeted climate finance, whereas (1,) (2) and (6) are areas for catalytic support based on the idea of additionality relative to the emphases within SDG action. Thus they come from asking what are the areas of action relevant for climate, which are least likely to be within (or 'under-emphasised' in) the SDG set of actions. In a sense, we are identifying the set of climate actions least likely to overlap with 'development' actions. We know the overlap and interweaving is very strong, but it is not total.

*Question 3*

Scale. It is hard to invent an 'appropriate level' for climate flows. It is not clear how that would be defined, both in terms of its relationship to finance for the SDGs and in terms of 'obligations' of rich countries. It is probably best to stick with the Copenhagen/Cancun US$100bn p.a. by 2020 as an historical agreement from the UNFCCC processes which balanced a number of considerations and which is an agreement that should be honoured. Then we can discuss flows within it and how they should be counted (as next section).

*Question 4*

What counts. One can count finance arising from (1)-(6) as they have been selected to cover areas less likely to be fully covered within the SDGs.

ODA finance for these areas should be fairly clear. MDB finance could, and perhaps should, be counted as a separate stream, since these flows are 'public' but usually involve strong loan elements (rather than being mainly grants). One could use multipliers for 'ODA-equivalence' if desired (with e.g. a higher multiplier for IDA-like finance).

Private finance should be counted when it is clearly triggered by ODA or MDB finance and action. In other words, we should count private finance that is generated in part by external assistance.

*Part 3: Creating numbers*

The above has identified 6 areas for the negotiations on climate finance for the Paris summit. There are four types of finance relevant here: domestic resource mobilisation (taxes etc.) or DRM; ODA and other sources of concessional flows; other public flows, including MDBs; and private international flows. Thus one can imagine a 6 by 4 matrix of flows with different kinds of finance going to each of the above six activities. If an activity is a row, then the proportions of different kinds of finance are likely to vary across rows.

Such a matrix could be constructed for different groups of countries: poorest or low-income developing countries (LIDCs), lower-middle income, middle-middle income countries.

There would be a corresponding set of matrices for the finance from the Addis Ababa conference. Some of the rows might overlap but there would be important differences. For example a key Addis-type of activity would be education, which would not appear directly in the rows of the Paris matrix.

In thinking about the scale and nature of climate finance for the Paris summit, it should be clearly recognised that overall infrastructure finance for emerging markets and developing countries could be of the order of US$3 trillion per annum in the next decade or so. It is important to see climate finance for the Paris summit, at US$100 billion per annum as catalytic in this context, rather than ‘gap-filling’.

There is considerable work that is needed to flesh out a systematic framework and assess the required magnitudes and sources of financing. The work should also examine implications for institutions and instruments in ways that could enhance overall investment flows, thereby enabling SDG and climate objectives.