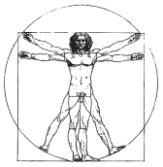
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Country (Adaptation) Funding Needs in the GCF

OPERATIONALISING THE 'COUNTRY NEEDS' INVESTMENT CRITERION

Submission to the GCF Investment Committee*

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* *This Submission is made in the author's personal capacity. It does not necessarily represent the views of Oxford Climate Policy (OCP), the European Capacity Building Initiative (ecbi) or its members.*

1. Introduction

At its fifth meeting (Paris, October 2013) the GCF Board decided *that the Fund will adopt a theme/activity-based approach to the allocation of resources* [and] *that, in relation to adaptation, resources will be allocated based on* […] *the urgent and immediate needs of vulnerable countries, in particular LDCs, SIDS and African States.*[2]

At its seventh meeting (Bali, May 2014) the Board – having decided, again, *that the Fund's initial investment framework will reflect the Fund's theme/activity-based resource allocation system as laid out in decision B.05/05* – adopted[3] an *initial investment framework*[4] with the proviso *to keep under review the initial investment framework and to take action as necessary* ***in particular with respect to the criterion on needs of the recipient countries in the investment guidelines*** [Decision B.07/06 (e), emphasis added]. The Board also requested the *Investment Committee to submit the following for consideration to the eighth Board meeting*:

(i) *Definitions for activity-specific sub-criteria and a set of activity-specific indicators,* […]*;*

(ii) *Minimum benchmarks for each criterion,* […]; and

(iii) *Identification and comparison of methodologies, that enable the Secretariat to assess the relative quality and innovativeness of comparable proposals in comparable circumstances* […].

On 7 August 2014, the GCF Secretariat issued a general call to observers for public input regarding these three points by 18 August. This submission has been written in response to this call. It is based primarily on the Paris and Bali Investment Framework Decisions (Decision B.05/05 and Decision B.07/06) and the Paris Background Paper on Allocation (GCF/B.05/05) and focuses on the issue of defining *activity specific sub-criteria*, in general, and *the criterion on needs of the recipient countries*, in particular.

The initial investment framework adopted in Bali (Annex XIV of the Bali Decision) includes a Table listing the following six criteria to be taken into account, and includes definitions and "coverage areas" (referred to as "sub-criteria" in the relevant background paper[5]):

(i) Impact potential
(ii) Paradigm shift potential
(iii) Sustainable development potential
(iv) Needs of the recipient (see Table A for details)
(v) Country ownership
(vi) Efficiency and effectiveness

Table A: Initial criteria for assessing programme/project proposals (excerpt)[6]

Criterion	Definition	Coverage area [Sub-criteria]
Needs of the recipient	Vulnerability and financing needs of the beneficiary country and population	• Vulnerability of the country • Vulnerable groups and gender aspects • Economic and social development level of the country and the affected population • Absence of alternative sources of financing • Need for strengthening institutions and implementation capacity

The aim of this submission is to consider how country needs can be taken into account while allocating adaptation resources (to vulnerable countries).

2. The Governing Instrument

Both the idea of a "thematic approach" and of a "needs-based allocation of adaptation funding to vulnerable countries" are based on the GCF Governing Instrument (GI). The GI section on allocation (paras 50 to 52) introduces two distinct allocation types – between themes, and between countries:

> 50. *The Board will balance the allocation of resources between adaptation and mitigation activities under the Fund and ensure appropriate allocation of resources for other activities*.
>
> 52. *In allocating resources for adaptation, the Board will take into account the urgent and immediate needs of developing countries that are particularly vulnerable to the adverse effects of climate change, including LDCs, SIDS and African States, using minimum allocation floors for these countries as appropriate. The Board will aim for appropriate geographical balance*.

However, both refer to allocating ***resources***, not ***activities***. The "allocation" of activities, as used in the Paris Decision, is dealt with under the heading of "Programming and Approval Processes" (para. 53). The idea of "activity-based resource allocations", in otherlo[n ZDU3 uDU3 NK ES ES9 V TES9 QDU3 9Tc

Assuming that, in the context of QPIs, both economic efficiency and distributive justice (equity) are equally legitimate allocative goals, Müller *et al.* (2013) suggest that the best way to overcome the inherent allocative conflict between the two objectives would be to divide the ***resource envelope*** (i.e. the resources earmarked for the purpose in question) into two separate sub-envelopes: one dedicated to achieving the 'biggest bang for the buck', and the other dedicated to satisfying the requirements of 'international distributive justice/equity'.

How does this compare with/relate to the "Theand Aivily

4. Country-based Allocations

The Paris Paper describes country-based allocations as follows: *Under a country-based allocation system, multilateral funds allocate resources for fixed periods, ranging from annual to their whole replenishment period. All multilateral funds make the point that country allocations are not entitlements. They are indicative amounts that are available if activities are proposed and approved within the allocation period. Funds can also be reallocated across countries at fixed intervals*.[10] *Country-driven choices could be enhanced by increasing the level of flexibility provided to countries in reallocating their adaptation and mitigation allocations.* […] *Resource flows to countries are predictable, enabling countries to engage with the Fund and other development partners in a more strategic way*.[11] *Upfront country allocations provide countries with greater predictability in resources and facilitate country-level programming*.[12]

This description not only highlights some benefits of country-based allocations but also some of the potentially problematic issues that have arisen, and the remedies that have been introduced in that context.

4.1. Issues and Remedies

The Paris Paper identifies three issues of concern that have been raised in the context of country-based allocations, namely the issues of potentially stranded resources, of how to deal with supplementary resources, and of an implied restriction of budgetary flexibility. Another issue which has been raised is an implied decrease in economic efficiency.

4.1.1. Stranded resources

What can be done if resources allocated to a country *remain unutilized because some countries are unable to bring forward proposals of acceptable quality in a timely manner*[13]? The Paris Paper gives a very clear answer: *All multilateral funds make the point that country allocations are not entitlements. They are indicative amounts that are available if activities are proposed and approved within the allocation period. Funds can also be reallocated across countries at fixed intervals*.[14] *Most multilateral funds have provisions to reallocate unutilized allocations towards the middle and the end of their allocation period. The policies and procedures for such reallocations attempt to increase the impact of the available resources while ensuring fairness to the affected countries*.[15]

Annex VIII of the Paris Paper presents how the International Fund for Agricultural Development (IFAD) actively manages its allocations in this respect.

4.1.2. Supplementary resources

Multilateral funds also obtain additional resources after the allocations have been made (e.g. supplemental contributions from Governments, exchange rate gains or better-than-expected returns on investments). Policies for allocating such additional resources are varied. They could be allocated to all or a selected subset of countries (e.g. countries with good performance scores) or for specific purposes such as set-asides. Additional allocations to countries could be in proportion to their original allocations, or based on a re-evaluation of the allocation formulas.[16]

4.1.3. Lack of budgetary flexibility

Country-based allocations can be interpreted as a form of earmarking which, while practiced by almost all governments – see Müller (2008)[17] – is generally regarded as sub-optimal fiscal practice. The solution, as revealed by government practise, is simply to declare the earmarked funds "off

budget", in other words to separate the budget from the earmarked resources as two administratively distinct funding streams. And the same is practised in multilateral funds through the use of set-asides:

> *Multilateral funds with country-based RASs allocate 50-85 per cent of available resources to countries. The remainder is set aside to meet other priorities of the fund. They have also often been used to support programmes with high cross-country spill-overs, such as global public goods and regional programmes (IDA, GEF, AsDF, AfDF). For instance, the AsDF sets aside 10 per cent of its available resources for sub-regional proposals and three per cent for national disaster response. Similarly, the GEF sets aside resources for a small grants programme, and the GEF Earth Fund sets aside resources to support community-level and private sector engagement, respectively*.[18]

4.1.4. Impediment to economic efficiency

In the context of competitive activity-allocations – such as by way of QPIs (see Box 1) – country-based allocations could reduce the economic efficiency of the system, say if the most competitive activity is in a country that has exceeded its resource allocation. There are no doubt a number of ways in which this could be addressed, but probably the simplest one is, as mentioned in Section 3, to create a sub-envelope for global competitive activity-based allocations.

4.2. Existing Best Practice and Equity

4.2.1. Existing Best Practice: Resource Allocation Systems

What exactly is the existing best practice for RASs? According to the Paris Paper, *the GEF, CIF and the Global Fund have recently evolved into three-tier structures. Each of these multilateral funds first allocates to specific themes. This is followed by allocations to countries and then to projects*.[19]

As concerns the three options described in the Paris Paper, two of the three funds listed as having a single-tier activity-based allocation model (Option 1)[20] in reality have an additional country-based tier,[21] and the description of the TA model (Option 2) does not mention any existing example at all.

Given this, the reasonable conclusion would seem to be that no multilateral fund (of significance) is presently allocating resources without a country-based tier. What does this mean? While the fact that all the other funds follow a certain practice does not necessarily mean that it is optimal, it does mean that it is (existing) best practice. In short, ***country-based allocations*** – with the sort of tools discussed in Section 4.1 – ***are the best practice in the field***.

4.2.2. Existing Best Practice: Country-based allocation rules

According to the Paris Paper, c*ountry-based allocations are rule-based in accordance with agreed principles, generally using a formula … based on two factors: country's needs and country's performance*.[22]

Country's needs often include two components – a measure of the overall scale of the problem and the intensity of the problem. Country's needs in multilateral funds focus on general development and are typically based on the scale (often measured by population) and the intensity of need (often measured by per capita gross national income). Theme-based multilateral funds measure needs based on their specific areas of focus.[23]

A practical example of such a scale-cum-intensity measure for adaptation funding needs – initially proposed in Müller (2013)[24] – is discussed in Box 2 below. At this point the key lesson to be drawn

is that according to best practice ***proportionality to 'country needs' is fundamental to distributive justice***.

4.2.3. Safeguarding against disproportionate resource concentrations

As it happens, best practice also suggests the necessity to address another equity problem, namely the potential for unfair/disproportionate resource concentrations. Disproportionate concentration of resources is one of the most common equity concerns in the context of resource allocation. The GI reflects this by stipulating that *the Board will aim for appropriate geographic balance*.[25] The background paper on Policies and Procedures for the Initial Allocation of Fund Resources[26] prepared for the sixth meeting of the Board in Bali (February 2014) suggested that to address this issue *the Board may introduce a universal single-country limit to ensure that Fund resources are deployed equitably across eligible developing countries.* […] *The single-country limit is an important part of the overall allocation system and should be reviewed by the Board from time to time. In the event that the Fund introduces a third-tier, country-based, allocation system in the future, the third tier would replace the single-country limit.*[27]

As discussed in Müller (2014),[28] the proposal of a single-country limit was highly controversial at the Bali meeting and was rejected. Moreover, it would not have been able to avoid the real issue, namely eligible countries finding themselves empty-handed.

What the Bali Paper failed to mention is that in order to avoid this situation it has become standard best practice to introduce (flat) single-country floor allocations (GEF, IDA, AF, LDCF and many others). Moreover, the GCF GI not only requires the Board to take into account the needs of particularly vulnerable countries in allocating resources for adaptation, but it also stipulates that this is to be carried out *using minimum allocation floors for these countries as appropriate* (para. 52).

Although the Board did introduce a 50 percent floor of adaptation resources for particularly vulnerable countries,[29] it stands to reason from the use of the plural "allocation floors" that the ***GI para. 52 language is referring to single-country floors***.

5. Summary, Key Lessons and Recommendations

5.1. Summary

1. ***International equity/distributive justice*** ("a fair share for each recipient country") and ***global efficiency*** ("biggest global bang for the buck") – provided the bang in question is well defined for all the relevant activities – are both legitimate resource allocation objectives that need to be addressed.

- 'Efficiency', in this context, can be dealt with solely in terms of 'activity-based allocations'. Indeed, for mitigation one of if not the most efficient activity-based way of allocating resources would be through fully competitive unrestricted Quantity Performance Instruments (say by reverse auctioning of certified emission reductions). 'Equity' however, pertains to the just distribution of resources between eligible recipient countries. It cannot be discussed, let alone assessed, without reference to country-wide funding figures.
- The initial investment framework of the GCF, however, has no reference to such country-wide figures, which makes it impossible to discuss, let alone address, the equity of the framework. The only reference to countries in the allocation criteria of the investment guidelines is in terms of country needs, which is indeed a key equity parameter, but cannot be operationalised without reference to country-wide funding figures.

2. Generally, efficiency and equity cannot be achieved simultaneously – through a single allocation – which is why the proposed way forward is to ***deal with the two objectives in separate allocations***, whereby each funding envelope is divided into two (not necessarily equal) sub-envelopes: one guided purely by efficiency, and the other purely by equity considerations.

- The exact nature of the allocation methods used in either of these sub-envelopes will depend on the thematic nature of the envelope in question. However, there are some general minimal commonalities. For one, it stands to reason that efficiency in practice cannot be achieved without some form of competition. It also stands to reason that equity minimally requires single-country floor allocations.
- Single-country floors are needed to deal with the issue of "unfair concentrations/geographic imbalance of resources". The crux of the matter is not really about "they are getting too much", but about "we are getting too little" (which means, in particular, that country caps will generally not address the problem). Apart from 'basic needs' dealt with these country floor allocations, equity may also require the consideration of country needs in a thematic sense.

3. ***Thematic considerations***: The exact nature of the allocation methods in the two sub-envelopes and their relative size will depend on the funding theme, as mentioned before.

- ***Mitigation***: It is relatively simple to compare mitigation activities with respect to their cost-effectiveness (efficiency). At the same time, it is not straightforward to define what country 'mitigation funding needs' might be. It thus stands to reason that equity could be achieved through the country floors alone, while the rest of the mitigation funding could be allocated on a purely competitive basis.
- ***Adaptation***: While it is possible to estimate adaptation funding needs of countries, it is not straightforward, if at all possible, to compare adaptation activities with respect to their cost-effectiveness: there is no globally comparable 'bang' in this context. This is why adaptation resources should be allocated principally in proportion to adaptation funding needs (in conjunction with the basic floor allocations).

5.2. Key Lessons

- Equity (distributive justice) as a resource allocation objective can be reconciled with the objective of economic efficiency ("biggest bang for the buck"), if applicable, by creating dedicated sub-envelopes in the relevant resource envelope: one to satisfy the requirements of equity, the others for efficiency.
- Equity minimally requires single-country floor allocations. Country needs, in accordance with best practice, can only be taken into account through ***country-needs-based allocations***, that is to say: country-based allocations in proportion to country needs.
- Country-needs-based resource allocations with single-country floors reflect existing best practice. As such, they are not entitlements, but equity benchmark amounts that are available if activities are proposed and approved within the allocation period.

5.3. Key Recommendations

I. ***Allocation of adaptation resources to vulnerable countries*:**

(i) In order to satisfy equity, the allocation of these resources should, in accordance with GI para. 52, use single-country floor allocations.

(ii) In order to comply with the Paris Decision that the allocation of these resources must take into account country needs,[30] a country-needs-based resource allocation (such as the one described in Box 2) should be included for this purpose into the Fund's initial investment framework. This is in accordance with the Songdo Decision *to keep under review the initial investment framework and to take action as necessary in particular with respect to the criterion on needs of the recipient countries in the investment guidelines*.[31]

II. ***General recommendations*:**

(i) All resource allocations should use single country floors.

(ii) All adaptation resource allocations should take into account country needs.

Box 2. Country-needs/risk-based allocation of adaptation resources

A recent paper on allocating adaptation resources[*] puts forward a concrete and practical proposal, based on lessons from fiscal transfer mechanisms, for a needs-based formula to allocate adaptation resources, in keeping with the best practice scale-cum-intensity paradigm discussed in Section 4.2.2.

In brief, the proposal is to estimate the scale of country *k*'s adaptation need by its ***Exposure Headcount*** (EH_k), that is to say the number of inhabitants exposed to climate change impacts, modified by a factor reflecting the intensity of this need, estimated by the relevant ***Vulnerability Index*** (v_k),[**] leading to a simple estimate for *k*'s Adaptation Need:

$$AN_k = EH_k \times v_k$$

– with the resources allocated in proportion to these needs.

As it happens, the right-hand side of this equation is the same as the product of *k*'s population (P_k) with its World Risk Index (WRI_k) developed by the United Nations University Institute for Environment and Human Security, Bonn/Germany:

$$AN_k = EH_k \times v_k = P_k \times WRI_k$$

– which is why the allocation in proportion to these needs could also be referred to as a "risk-based" country allocation.

[*] Müller, B. (2013). *The Allocation of (Adaptation) Resources: Lessons from fiscal transfer mechanisms*. Oxford Energy and Environment Brief, September 2013

[**] If for some reason the use of vulnerability indices is seen to be problematic, one could instead use prosperity (GDP/cap) levels to estimate the needs intensity: $AN_k = EH_k : gdp_k$

Endnotes

[1] Managing Director OCP: www.oxfordclimatepolicy.org/publications/mueller.shtml
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[2] Decision B.05/05.

[3] Decision B.07/06.

[4] Annex XIV to Decision B.07/06.

[5] GCF/B.07/06.

[6] The other criteria are strictly about activities, and not about countries and their needs, which is the topic of this submission.

[7] GCF/B.05/05, Business Model Framework: Allocation, 30 September 2013

[8] Müller, B., Fankhauser, S., and Forstater, M. (2013). *Quantity Performance Payment by Results: Operationalizing enhanced direct access for mitigation at the Green Climate Fund*. OIES Working Paper EV 59, July 2013.

[9] Bali Paper, paragraph 6.b.

[10] Paragraph 28.

[11] Paragraph 46, Option 3.

[12] Paragraph 25.

[13] Paragraph 29.

[14] Paragraph 28.

[15] Paragraph 29.

[16] Paragraph 30.

[17] Müller, B. (2008). *To Earmark or Not to Earmark? A far-reaching debate on the use of auction revenue from (EU) Emissions Trading*. Oxford Institute for Energy Studies EV 43, November 2008.

[18] Paragraph 27.

[19] Paragraph 26.

[20] Paragraph 46, *Option 1: Activity-based (A). This is a single-tier system, is the simplest to set up and is similar to the systems currently in use at the Adaptation Fund, SCCF and LDCF*.

[21] The Adaptation Fund Board Decision B.13/22 approves *a cap of US $10 million for each country funded for support by the Adaptation Fund*, while the LDCF country cap has recently (20 April 2014) been raised from $20m to $30m. See, for example, paragraph 7 in *Progress Report on the Least Developed Countries Fund and The Special Climate Change Fund*, GEF/LDCF.SCCF.16/04 May 1, 2014

[22] Paragraph 28.

[23] Paragraph 29.

[24] Müller, B. (2013). *The Allocation of (Adaptation) Resources: Lessons from fiscal transfer mechanisms*. Oxford Energy and Environment Brief, September 2013

[25] Paragraph 52.

[26] GCF/B.06/05. *Policies and Procedures for the Initial Allocation of Fund Resources*. 7 February 2014

[27] Paragraph 20.

[28] Müller, B. (2014). *Concentration of GCF resources: what is at issue?* OCP/ecbi/OIES Discussion Note, March 2014.

[29] Decision B.06/06, Paragraph (a)(ii).

[30] Decision B.05/05, (d)(ii).

[31] Decision B.07/06 (e).