

**The Impacts of Combining Climate Finance with ODA on the Volume of  
Development Finance**

By

**GEBREYESUS, Kalekristos Zerisenay**

**THESIS**

Submitted to

KDI School of Public Policy and Management

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For the Degree of

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Committee in charge:

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## ***Abstract***

*There is a general agreement that climate finance has to be scaled up to deal with climate change. However, there is stern disagreement between developed and developing countries in their views of climate finance and its management. Although UNFCCC and subsequent protocols clearly call for increased “new and additional” climate finance, there is no legal definition of what “new and additional” finance mean, and this has resulted in contending interpretations of the terms.*

*Developing countries interpret “new and additional” as a source of money out of annual national budget and additional to existing ODA target of 0.7% of GNI. They also insist on separating climate change finance from ODA claiming that combining the two funds allow donor countries to divert resources from development finance to climate finance and thus decrease funds they receive for economic growth and development. Conversely, developed countries support merger of climate finance with OD but clearly lack common interpretation of the “new and additional” principle.*

*This study examines the impact of combining climate finance with ODA on development finance. Due to unavailability of time series data for climate finance, the study systematically measures ODA percentage of GNI since 1960 and the proportion of climate finance in it. The study finds that the decade average ODA against share of GNI has decreased throughout the five studied decades while the proportion of climate finance in it increased. Based on this systematic measurement, the study concludes that combining ODA and climate finance decreases development finance developing countries receive.*

## **Introduction**

This study aims to assess the impacts of combining climate finance with ODA on the volume of development finance developing countries receive. Since climate finance started to be reported in 1998, the study focuses on post-1998 period.

Climate change is one of the major challenges facing the world today. In response to these changes international efforts are being exerted to mitigate greenhouse gas (GHG) emissions and adapt to the impacts of climate change, particularly in developing countries. However, how to raise and channel climate change finance to mitigate climate change and enhance adaptability to climatic changes is a looming issue.

There is a stern disagreement between developed and developing countries in their views of climate finance and its management. This has resulted from differing interpretation and understanding of the “new and additional” principle enshrined in the 1992 United Nations Framework Convention on Climate Change (1992, Art. 4.3) and subsequent protocols and accords such as the Kyoto Protocol (1997, Art. 11.2), the Bali Action Plan (2007, Para 1 e) and the Copenhagen Accord (2009, Para 8) (World Resource Institute 2010). All these international legal instruments call for developed countries to provide “new and additional” climate change finance to developing countries but seriously fail to give clear definition of what “new” and “additional” means.

As a direct consequence to lack of definition of the “new and additional” principle, different interpretations have resulted. This, added with conflicting interests, the positions of developing and developed countries are far from each other. In addition to this, various

international organizations and scholars have different views and interpretations of the “new and additional” principle.

Developing countries interpret “new and additional” as a source of money out of annual national budget and additional to existing ODA target of 0.7% of GNI (Stadelmann et al. 2010). These groups of countries call for climate finance to be separate from traditional ODA on the claim that targets of ODA are socio-economic development whereas the targets of climate finance are stabilizing greenhouse gases concentration in the atmosphere and assisting developing countries, primary victims of climate change, reduce their vulnerability to the impacts of climate changes and enhance their adaptive capacity and resilience to climate changes (OECD-DAC 2010).

For developing countries, since climate change is caused by developed countries from the period of industrial revolution, climate finance is an entitlement and not aid and has to be separate from ODA (World Bank 2010). For this group of countries, merging climate finance with ODA means transforming it from obligatory to voluntary contribution and thus subjecting it to domestic economic conditions and political decisions of donor countries. Further they claim that, this not only makes the funds inadequate and unpredictable but also involves loan, which developing countries do not want to pay back as it is the case with ODA (Ibid). Apart from this, developing countries argue that merging the two funds under ODA will allow donor countries to divert resources from ODA to climate finance without real increase in their ODA budget, which ultimately result in reduced development finance for economic growth and poverty alleviation (Global Canopy Program 2009).

Contrary to the views and position of developing countries, developed countries are highly reluctant to consider climate finance as obligation. On the management side, developed countries argue that they do not see any justification for treating the two funds separately since they claim that climate and development are highly related at project level and thus be combined together (World Bank 2010).

Nevertheless, developed countries themselves do not have a unified position on how to address the question of climate finance management. They also greatly differ in choosing ODA baseline from which climate finance to be considered as new and additional. Generally, the positions and suggestions of European Union (EU) countries on the management and setting of ODA baseline can be categorized in to four points (Brown et al. 2010).

1. **Climate finance is classified as aid, but additional to (over and above) the ‘0.7 %’ ODA target.** Under this option climate finance is considered as additional only if it is over and above 0.7 percent of GNI of ODA. This option is highly favored by developing countries, Sweden and the Netherlands.
2. **Increase on 2009 ODA levels spent on climate actions.** This definition sets the 2009 level as a baseline and any new ODA above this benchmark and channeled to climate finance can be considered as additional. This option is supported by Germany but it is the most unwelcome by developing countries.
3. **Rising ODA levels that include climate change finance but where it is limited to a specified percentage.** This definition suggests that climate finance should be part of ODA but limited to a certain percent (10 percent). Under this UK-supported option, non-ODA sources of climate finance will be needed to meet growing demands.

4. **Increase in climate finance not connected to ODA.** This definition suggests a complete separation of ODA and climate change finance. Under this approach ODA should continue to be used for socio-economic development purposes, and finance for climate change should come from other sources of finance not categorized as ODA.

The different interpretations and positions between developed and developing countries and lack of a united position within developed countries have negatively impacted progress on climate change abatement and adaptation efforts.

Addressing uncertainties around possible consequences of combining climate finance and ODA is significant in facilitating the unending negotiation on climate finance between developed and developing countries. Research that proves or refutes claims that combining climate finance with ODA decreases the volume of funds is hardly available. This has made taking an informed decision and reaching a negotiated agreement a long process if not impossible. Therefore, by testing the question at hand quantitatively and qualitatively, the study tries to disclose the real consequences of combining climate finance with ODA. Since climate finance has started to be reported in 1998, the study focuses on post-1998 period.

I claim that combining climate finance with ODA decreases or stagnates the size of development assistance that developing countries receive. This happens because merging development and climate finance allow donor countries to divert resources from ODA towards fulfilling their climate pledges without real increase in their overall budget. This implies that an increase in climate finance is less likely to be achieved without offsetting effect on the size of development assistance. Data shows that increases in climate finance decreases or stagnates

ODA size or at times the volume of climate finance and ODA decrease or increase simultaneously.

Looking the issue from the principle of “new and additional” perspective makes the result much worse. Although the “new and additional” principle has no legal definition; developing countries, United Nations, major international organizations and civil societies understand the term “new” as a source of money outside the national budget and “additional” as over and above ODA (0.7% of GNI) target. The fact that as of 2015 only 5 OECD-DAC member countries have achieved the 0.7% target implies that money earmarked for climate finance from the rest DAC members has jeopardized ODA level that should have gone to developing countries for socio-economic development works.

To support my claim, I used secondary data from the OECD, World Bank, Oxfam and other organizations report on the volume of ODA and climate finance since 1998 where OECD countries started reporting their climate finance. The study has tested the relation between the two variables (ODA and climate finance) and analyzed how increases or decreases in climate finance affected the size of ODA. It has also examined the contribution of other factors in the increase or decrease of ODA.

The study has limitations. Time series data for climate finance is unavailable. This made conducting comprehensive study on the relation between climate finance and ODA difficult. The fact that OECD is the only organization that provides comprehensive ODA and some climate finance data, the study is fated to grossly rely on OECD aid reports. This is not without problem. Since OECD treats climate finance as part of ODA, reports from the organization are susceptible

to double counting – funds disbursed to mitigate greenhouse gases (GHG) and adapt to impacts of climate change may be double-counted both as climate finance and development assistance.

## Literature Review

Literature on concrete impacts of combining climate finance with ODA on the size of development finance is hardly available. However, sovereign states, organizations, civil societies and scholars have extensively dealt with potential impacts of combining climate finance with ODA.

The United Nations Framework Convention on Climate Change (UNFCCC) adopted in 1992 the principle of “new and additional” climate finance. However, the Convention failed to give legal definition of what “new” and “additional” climate finance mean. This lack of legal definition has exposed the new and additional principle to different contending interpretations and debate.

Developing countries, civil societies and development scholars interpret “new” as source of finance out of national budget, and “additional” over and above ODA target (0.7% GNI) (Reality of Aid Africa 2011).

Oxfam understands “new” as a source of finance outside national budget and “additional” as “over and above” the existing target (0.7% of GNI) of development aid (Oxfam 2012). Oxfam further asserts that climate finance has to be handled separately from ODA. It also insists that climate finance, as opposed to ODA, has to be an obligatory contribution (Oxfam 2012). The organization argues that combining the fund with ODA will change it to voluntary contribution as it is the case with ODA. This is particularly important in light of the unpredictable and inadequate nature of ODA often due to economic conditions and political decisions in developed countries. Oxfam further claims that merging the two funds will allow shifting funds from ODA

to climate finance, thereby decreasing the volume of funds developing countries receive for poverty alleviation, which further undermines global fight against poverty.

Conversely, in order to avoid the risk that the “new and additional” principle poses to the majority of OECD-DAC countries’ performance on the 0.7% GNI target, OECD does not refer to the “new and additional” principle in its dealings. Rather it asserts the inherent relation between climate and development thereby justifies combining climate finance with ODA (Steele, 2015). The OECD also fails to consider the impacts that merging climate finance with ODA will have on the volume of exclusive socio-economic development finance.

The varying interpretations of the “new and additional” principle and conflicting economic interests of OECD-DAC and developing countries has negatively impacted the possibility of reaching an agreement on the management of climate finance and ODA. It seems unarguable that combining the two funds is in the interest of OECD-DAC countries while separation is good for developing countries.

The “common but differentiated principle” of UNFCCC (Art. 2) further heats the debate (Brown et al. 2010). Commonly interpreted as “the polluter pays principle,” it asserts that funds must be adequate and predictable and tacitly call for climate finance to be separate from ODA, as the latter is voluntary contribution usually subject to changes in economic performance and political decisions of donor countries. The Bali Action plan further reinforces this by stipulating that funds must be adequate, predictable, sustainable as well as new and additional (schalatek et al. 2011).

However, in contrast to this, climate finance is given away from aid budgets through different channels. It is reported that climate finance is being delivered through more than 75 bilateral and multilateral agencies, making tracking efforts highly difficult (Sierra et al., 2013).

In addition to disagreements on the management of the two funds; the role of climate finance in alleviating poverty is dubious. In contrast to claims of OECD, Axel and Katharina Michaelowa (2010) maintain that greenhouse gas mitigation projects have limited impact on poverty alleviation. As a result, they call for setting up separate funds to avoid diversion of resources aimed at poverty alleviation.

Similarly, Oxfam asserts that money earmarked for GHG mitigation schemes hardly helps the poor and vulnerable communities. It estimates that less than 10 percent of climate funds have reached the poor in vulnerable countries to adapt the impacts of climate change. In other words the organization claims that much higher resources are allocated for mitigation than adaptation projects, a scheme that is less important for the poor.

By the same token, the World Bank takes a position that public funds have to be scaled up simultaneously to achieve the MDGs and combating climate change. The Bank further reveals the complexity of counting climate finance as additional for majority of OECD countries that have not met their 0.7% GNI target set in 1970.

A study by Caparrós, Perea and Tazdait finds that funding transferred to developing countries for GHG emission reduction decreases volume of development aid in the long run though both climate and development funds may increase at an initial stage (Caparros et al. 2006). Likewise, a study by Axel and Katharina Michaelowa (2005) finds that increased

mitigation funding reduces the size of ODA in the long run although both mitigation finance and ODA might increase in the short run mainly because of enthusiastic initial contribution.

OECD, clearly, has a different position. According to the organization, climate change finance towards mitigation and adaptation purposes are highly related with development projects and thus should be combined together. By indicating the organization's allocation of 15 percent of ODA as climate change related fund in 2010, OECD DAC data assures that climate change finance is part of ODA delivered by the organization (Fozzard and Steele 2012).

OECD is not the only one to defend combining climate finance with ODA. Homi Kharas of Brookings Institution asserts that climate finance and ODA are not necessarily in conflict with each other though he raises the importance of agreed allocation (balancing) of funds for both purposes (Kharas 2016). Similarly, Steele recognizes the problem of separating climate adaptation finance from development fund in least developed countries and agrees with merging of the two on the basis that development projects on health, education, water, and sanitation and food security have to be resilient through adaptation programs (Steele, 2015). However, he undermines the importance of merging climate change mitigation finance with ODA on the claim that the link between mitigation and poverty alleviation is weak and argues that climate finance for Middle Income Countries(MICs) which are main recipients of mitigation finance has to be additional to ODA level of 0.7 percent GNI (Steele, 2015).

Furthermore, Fozzard and Steele favorably join OECD's position. According to them, distinguishing development and climate change, especially adaptation policies, are often difficult. They claim that most policies, programs and projects fall between pure development and pure

adaptation. Hence it is difficult to isolate adaptation finance from development budget (Fozzard and Steele 2012).

## Discussions

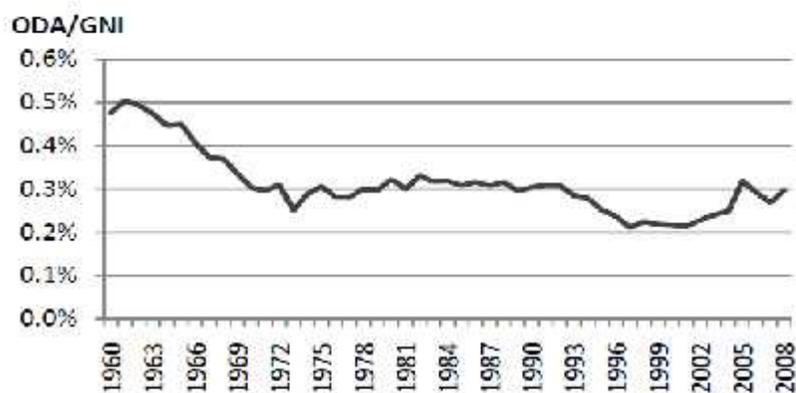
Given fragmented nature of climate finance, lack of proper reporting and unavailability of time series data for climate finance (Steele 2015), lack of transparency and many other concerns; it would be difficult to conclude based on solid evidences that combining climate finance with ODA decreases the size of ODA developing countries receive. However, examining the well-reported OECD-DAC time series data against the proportion of climate finance in it and other separate studies on climate finance and development enables reach to a conclusion.

The first and perhaps most important point in addressing the main concern of this study is reference to Article 4.3 of the 1992 UNFCCC principle of “new and additional finance.” Although the principle lacks definition, I agree with the widely accepted interpretation that “new” means a source of finance different from public finance such as private finance whereas “additional” means public finance additional to ODA which was agreed in 1970 to be 0.7 percent of OECD-DAC countries’ Gross National Income (GNI).

The fact that as of 2015 only five countries (UK, Norway, Sweden, Denmark and Luxembourg) of OECD-DAC countries have achieved the target of 0.7 percent of their GNI as ODA entails that public finance allotted for climate finance from other OECD-DAC countries jeopardize the volume of development assistance flowing to LDCs. In other words, for a country to be considered as climate financier, it has first to achieve the goal of 0.7 percent of its GNI as ODA (Oxfam 2012). In this sense, for the great majority of OECD-DAC countries, it is a long way for climate finance to be additional to 0.7 percent of their GNI especially considering the downward trend of ODA as percentage of GNI since 1960. Even for the five countries that are commonly considered to have achieved the goal, climate finance is counted as ODA (Steele

2015) and there remain few steps to go for these countries before achieving the goal of 0.7 percent of GNI in which climate finance is not part of ODA.

**Figure 2: Ratio of ODA to GNI over time**



Sources: OECD 2010 (ODA), World Bank (GNI of OECD countries)

Average ODA/GNI Ratio of OECD-DAC countries by percent	1960-1969	1970-1979	1980-1989	1990-1999	2000-2009
	0.45	0.32	0.33	0.27	0.27

Source: OECD 2011

*The table shows that in the five decades between 1960 and 2009 OECD-DAC's ODA share of GNI consistently decelerated except the slight increase scored during the period of 1980-1989 from the previous decade. This shows that OECD-DAC countries are getting far from reaching the committed 0.7 percent of their GNI as ODA. In fact in the last two decades from 1990-2009 ODA's share of GNI considerably declined from the previous decades. This is paradox since the start of climate financing as a new source of assistance in 1990s should have pushed ODA's share of GNI upward. This indicates that financial resources donated as climate finance in the last two decades are hardly additional and they are simply diverted from ODA.*

Apart from failure to satisfy the 0.7 percent of GNI as ODA, there is clear evidence that climate finance proportion of ODA is growing steadily, leaving ODA purely dedicated for economic growth and poverty alleviation falling. For instance the annual average for 2005-2007 climate-related finance for OECD-DAC countries was 3.2 percent of total ODA (OECD, 2009). In 2010 climate change-related DAC aid represented 15 percent of total ODA (OECD-DAC 2012) while in 2013 and 2014 the proportion rose to 17 percent (23 billion USD) and 20 percent of total ODA respectively (Steele 2015).

Climate finance share of ODA by percent	2009	2010	2011	2012	2013	2014
	9	15	----	----	17	20

Astonishingly, 60 percent of the 23 billion USD climate finance was allocated to middle income countries for climate change mitigation purposes. This shows that the proportion of climate finance in ODA is not only growing but also bigger amount (60 percent) of the stated proportion of ODA is set aside to middle income countries (not to least developed countries) for climate change mitigation purposes, which development scholars widely regard it to have very weak connection with poverty alleviation.

#### USD million, 2011 value

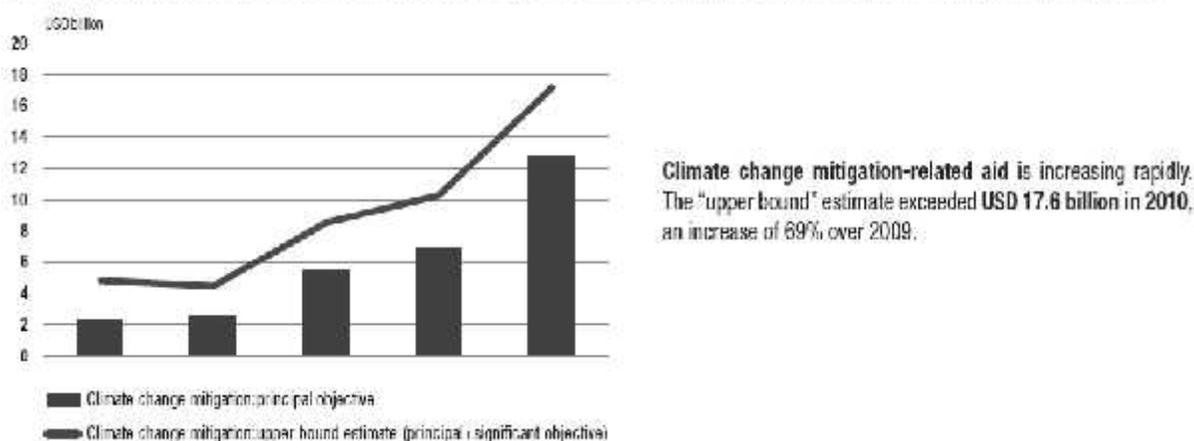
Year	Total ODA	ODA growth %	ODA GNI%	Climate finance	Climate finance growth %	Share of ODA %	Non Climate ODA	Non Climate ODA growth %
<b>1998</b>	<b>52 277</b>	..	<b>0.23</b>	<b>2444.1</b>	..	..	<b>49832.9</b>	..
1999	53 558	2.45	0.22	3254.3	33	..	50303.7	0.84
2000	53 970	0.76	0.22	2424.2	-25.5	..	51545.8	2.46
2001	52 697	-2.36	0.22	1745.0	-28	..	50952	-1.15
2002	58 588	11.2	0.23	1596.7	-8.49	2.4	56991.3	11.85

2003	69 450	18.5	0.24	3471.8	117.4	5.1	65978.2	15.76
2004	79 876	15	0.25	3260.8	-6.1	4.2	76615.2	16.12
2005	107 865	35	0.32	3978.8	22	3.2	103886.2	35.59
2006	104 856	-2.78	0.3	3969.4	-0.23	3.2	100886.6	-2.88
2007	104 254	-0.57	0.27	3990.2	0.52	3.2	100263.8	-0.61
2008	122 003	17	0.3	8451.8	111.8	8	113551.2	13.25
2009	119 822	-1.78	0.31	10158.0	20.2	7.1	109664	-3.42
2010	128 292	7	0.32	26532.6	161.2	15	101759.4	-7.2
2011	133 716	4.2	0.31	20775.4	-21.7	13	112940.6	10.98
<b>2011:1998</b>		<b>155.8</b>			<b>750</b>			<b>126.6</b>

*The table contains 14 years data (1998-2011) for ODA and climate finance. This period is selected because OECD-DAC countries started to report climate change finance from 1998. The data shows that the proportion of climate finance in ODA increased over time especially since 2008. The data for ODA was taken from OECD while data for climate finance was collected from various sources.*

The threat climate change mitigation finance to Middle Income Countries (MICs) pose to poverty alleviation funds in LDCs is further visible when we compare the figure allocated for the two groups of countries towards implementation of their respective programs. The average mitigation finance for MICs between 2010 and 2012 was 10.47 billion USD while the total ODA for LDCs in 2011 was only 45.49 billion USD. The fund earmarked to the relatively well-doing economies is only for mitigation programs while the total ODA allotted for the huge number of LDCs where big majority of their people live under abject poverty is for multi-programs – socio-economic growth, poverty alleviation, climate adaptation and climate mitigation.

FIGURE 1: TRENDS IN CLIMATE CHANGE MITIGATION-RELATED AID, 2006-10, bilateral commitments, USD billion, constant 2009 prices



Source: OECD 2011

There are two main reasons behind heavy support of developed countries to mitigation programs than adaptation and poverty alleviation. The first is meeting their carbon emission reduction commitments under various protocols, including the Kyoto Protocol. By assisting mitigation schemes in MICs, developed countries hit two heads with one stone. Simple diversion of their ODA to mitigation projects such as solar and wind power, oil-efficient public transport, subway etc allows them meet their commitment to reduce carbon emissions without necessarily affecting their economies at home. Besides, it enables developed countries to play a dual game as development and climate financier without real or substantial increase of their budget for ODA.

The second reason is a commercial one. As carbon emission reduction significantly involves new technologies, which is dominantly possessed by developed countries, funding emission reduction projects allows them sell their products to recipient countries and take back the money transferred as aid.

Simple observation of finance allocation that was raised by developed countries in response to their commitment at the 2009 Copenhagen Accord further gives clear landscape of ODA and climate finance.

At the Copenhagen Accord, developed countries committed to donate \$30 billion as fast start [climate] finance (FSF) between 2010 and 2012; to annually provide \$100 billion starting from 2020 and to make such finance new and additional, sources from private and public and bilateral and multilateral institutions (Kharas 2016). In excess of their commitments, developed countries donated \$35 billion from 2010 to 2012. However, 80 percent of the FSF was given in the form of ODA – significantly increasing the size of ODA from the 2009 level (Ibid). This increased the share of climate finance in ODA from 9 percent in 2009 to 20 percent in 2013 (Ibid). This implies that 20 percent of ODA was allocated to activities that may not have direct impact in reducing poverty. In another scenario, there is clear evidence that OECD-DAC pledges for FSF was fulfilled by simply diverting funds from ODA. For instance UK' \$2.5 billion pledge was entirely met from its already announced development aid budget (Reality of Aid Africa 2011).

To make matters worse, climate-related aid is geared more towards GHG mitigation than adaptation purposes. As upper-middle-income and middle income countries emit greenhouse gases more than LDCs do, the lion share of climate finance goes to upper-middle-income and middle income countries (Nakhoda and Marigold 2014). The fact that no low-income country was among the first ten Fast Start Finance (FSF) recipient countries shows that the proportion of climate finance in ODA is not only increasing but also it is delivered to upper-middle-income

and middle income countries, leaving LDCs to suffer from double-edged sword - decreased size of ODA and very limited access to meaningful climate finance (Kharas 2016).

The emphasis donor countries place to mitigation than adaptation means that big portion of climate finance is being spent on non-socioeconomic development projects. For instance, OECD report (OECD, 2012) shows that the funds allocated for mitigation-related and adaptation-related funds in 2010 were 17.6 billion USD and 8.9 billion USD respectively. Learning that this allocation was made since 2009 after LDCs and international organizations' long cry for the establishment of adaptation funds tells that in the pre-2009 years all climate finance was meant for mitigation schemes and thus can be said that big damage was made on efforts of poverty alleviation.

## **Conclusion**

The absence of time series data for climate finance and double-counting problem associated with it makes studying impacts of combining climate finance with ODA on the development finance developing countries receive difficult. However, continued decline of ODA share of GNI from 1960 to 2009 and increased share of climate finance in ODA shows that development finance exclusively allocated for socio-economic development is shrinking. Thus combining climate finance with ODA decreases the volume of development aid to developing countries.

The great emphasis donors place to climate mitigation and allocation of lion share of mitigation fund to upper-middle-income and middle income countries further decreases development and adaptation funds for LDCs.

If climate finance continues to be under-reported, and a clear-cut border that separates climate finance from traditional official development assistance is not drawn, donor countries will continue to manipulate figures of the two funds often with risk of double counting. Besides, within climate finance there is a compelling need for separation of mitigation and adaptation funds with balanced and fair allocation. If the international community fails to address this mix-up, there is no doubt that donors will use the loophole to finance mitigation efforts in middle income countries and leave LDCs without adaptation funds which certainly will worsen quality of life in these countries.

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