

5

Mainstreaming into Budgeting Processes

This chapter describes approaches to budgeting and financing for poverty-environment mainstreaming, which includes influencing the budgeting process at various levels (e.g. revenue and expenditure) and emphasizing the contribution of ENR to public finances. The chapter also describes how budgets actually work, how poverty-environment mainstreaming has contributed to influencing public budget circulars and the assessment methodologies for selecting public investment programmes in support of pro-poor environmental sustainability.



5.1 Engaging in the Budgeting Process

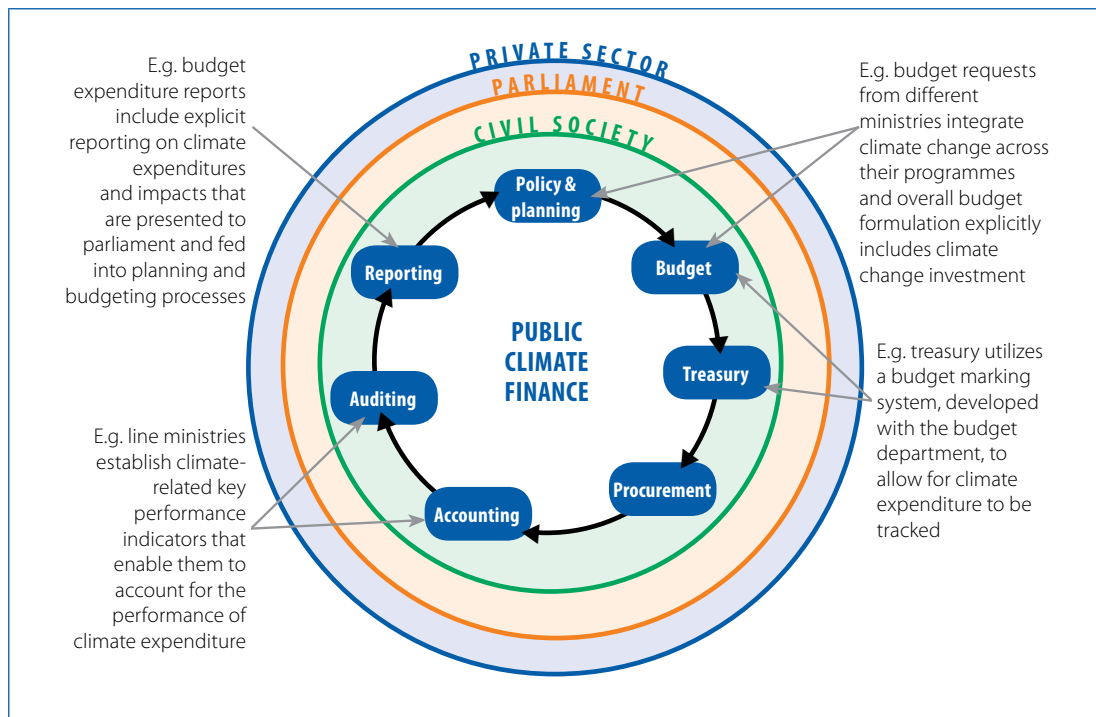
The budget is the primary political and economic expression of a government. It includes a government's decisions on both expenditure—what to spend on—and revenue raising—what to tax and levy charges on. These public fiscal policy decisions incentivize private sector investments.

The budget can have either positive or negative effects (or both) on climate and the environment, depending on whether it reflects “positive” expenditures and fiscal policies or “negative” expenditures and policies. Positive expenditures support environmental and climate priorities such as sanitation, watershed and forestry management, soil erosion control

and climate-proofing infrastructure. Positive fiscal policy includes incentives for clean technology or private forestry plantations. Negative expenditures undermine climate and environmental objectives, such as government-funded fossil fuel power plants or state-led land clearance. Negative fiscal policy includes tax breaks for private fossil fuel investments or for private investors to clear forests, or subsidies for pesticides and fertilizers.

The budget is a complex political and technical exercise, and as such contains multiple entry points for pro-poor environmental and climate mainstreaming. The main steps in the budget process are budget planning and formulation, budget execution and implementation, and budget monitoring and accountability. [Figure 5.1](#) shows how climate change in particular can be integrated at these different steps. This

Figure 5.1 Integrating Climate Change into the Budget Process



Source: Palmer et al. 2014.



chapter discusses each of the key entry points and explains what can be done to integrate climate and/or the environment at each point.

5.2 Mainstreaming into the Budget Formulation Process

Ministry of Finance Budget Call Circulars and Guidelines

The ministry of finance starts the budget process by sending out a budget call to line ministries with a budget ceiling. The budget may include specific criteria or priorities for public expenditure. A number of countries have included sustainability from an environmental and/or climate perspective as one of these priorities. Nepal is one such example where climate has been prioritized with UN support so that more climate-resilient projects may receive public funding. And the 2014/15 Malawi budget guidelines state that

The contribution from prudent use of natural resources, environmental management and climate resilience is crucial in order for Malawi to achieve national sustainable development. There is need to ensure that all projects comply with environmental sustainability guidelines. This has immense potential to provide significant benefits from sustainable resource use and management and climate proofing of the economy and presents a rare opportunity for improved livelihoods of present and future generations of Malawians (Government of Malawi 2014).

The process followed in Malawi to successfully integrate poverty and the environment into budget guidelines is set out in [box 5.1](#).

Ministry of Planning Capital Investment Project Screening

Most budgets are separated into routine operation and maintenance and one-off investment, or capital, projects. These may also

Box 5.1 How Malawi Included Poverty and the Environment in Its Budget Guidelines

Demonstrating the Benefits

The Malawi Ministry of Economic Development Planning, with PEI support, conducted an economic analysis of sustainable natural resource use in the country (Yaron et al. 2011). The analysis showed that unsustainable natural resource use is costing the country the equivalent of 5.3 per cent of its GDP. It also found that soil erosion reduces agricultural productivity by 6 per cent; recovering this yield would lift an additional 1.88 million people out of

poverty between 2005 and 2015.

Providing Guidance

The results of the economic analysis focused both the Ministry of Economic Development Planning and the Ministry of Finance on the concept of environmental sustainability. PEI provided specific guidance on how to better integrate sustainable ENR management in Malawi's budget process. To this end, along with the Overseas Development Institute, it developed guidelines that were

adopted in 2012, and followed up with substantive dialogue with the government.

Results

The 2013/14 budget guidelines issued by the Ministry of Finance (Malawi Government 2014) included a chapter on adherence to the sustainability guidelines; this was further strengthened in the 2014/15 guidelines, which include references on how poverty reduction and growth are linked to environmental sustainability.

Source: PEI Africa.



be managed by separate parts of government; for example, the planning ministry may have a role in approving and monitoring the capital budget. For capital investments to receive public funding (including donor funding), projects may have to undergo some form of screening to assess their costs and benefits; this can be an important entry point for mainstreaming support. Bangladesh's Planning Commission has a separate format, called a project pro forma, which it uses to appraise all capital projects. With UN support, this project pro forma now mainstreams issues of poverty, gender, climate, environment and disaster management. In Viet Nam, UN support has enabled the country to screen capital projects for their contribution to the country's green economy strategy. A range of other countries are also receiving UN support aimed at building the skills of officials in planning and line agencies so they can knowledgeably assess and prioritize climate-related capital projects.

Line Agency Costing of Required Expenditures

In order to submit their expenditure plans to the ministry of finance, line agencies need to be able to provide prioritized and costed programmes. Unfortunately, while there are many examples of environmental, climate and biodiversity strategies with extensive programme recommendations, there is no prioritization or costing information available to allow these to be presented to the finance ministry for funding. UN support has been provided to line agencies in Cambodia to develop prioritized and costed sectoral strategies for climate change. In Mozambique, the Ministry for Coordination of Environmental Affairs has successfully institutionalized cross-sector environment unit meetings prior to the submission of the sector annual economic and social plans; this has ensured the inclusion of costed environmental and climate change activities ([box 5.2](#)).

Box 5.2 Including Poverty-Environment Objectives in Sector Plans and Budgets in Mozambique

Mozambique's central and sector ministries are encouraged to have environmental focal points. Today, 15 ministries—including the Ministry of Finance—have appointed such focal points. During the preparation process of the sector annual economic and social plans which include the sector budget, the Ministry for Coordination of Environmental Affairs invites these focal points to environment unit meetings. These meetings have become a routine part of the

annual planning conducted by the ministry and the sectors and have ensured the inclusion of poverty-environment-related objectives/activities in sector plans and budgets.

One tool used for reviewing sector plans and budgets is the cross-cutting mainstreaming matrix launched by the Ministry of Planning and Development in 2011. The matrix includes guidance on the mainstreaming of eight issues,

including the environment and gender.

Vilela de Sousa, Deputy Director at the Department of Planning at the Ministry for Coordination of Environmental Affairs, highlighted in July 2013 how many sector ministries, including the Ministry of Defence, now recognize their own responsibility in promoting pro-poor sustainable development and why it is beneficial to sector targets.

Source: PEI Africa.



5.3 Mainstreaming into the Budget Execution Process

Influencing sector budgets as outlined above is important in having an impact on the ground, but equally important is being able to support the capacity in implementation. One of the key challenges across governments that may be linked to limited capacity and weak systems—including for procurement—is that actual expenditures are below planned expenditures, leading to ministries having low physical and financial delivery rates. Capacity constraints are particularly apparent when sectors are to spend funds on inputs in areas outside their traditional scope, such as environmental sustainability, climate and gender. It is in this context that the ongoing substantive engagement referred to in chapter 3 is crucial. Lack of capacity may also be linked to lack of awareness and/or competing demands.

Problems also arise when budgets are delivered to line ministries at different times—often later—than expected. In particular, some environmental expenditures may be very time sensitive, notably, afforestation. UN support demonstrated to Indonesia that much of its Ministry of Forestry budget for afforestation has been arriving after the rainy season, meaning that the tree survival rate has been very low. Another timing/budget consideration pertains to funding for postdisaster clean-up, which is increasingly linked to climate change. Ex ante investments before a disaster might be much more cost-effective than funds made available after the disaster. Better linking of humanitarian and ex post disaster expenditures needs much more attention.

5.4 Mainstreaming into Budget Monitoring and Oversight

Budget reporting, monitoring and oversight by the central audit institutions as well as by legislatures and civil society comprise the final step in the budget process. This is a critical step that can hold government accountable for delivering on commitments and priorities. It involves assessing spending against stated policy priorities, assessing fund allocations and expenditures, and determining corresponding benefits for target groups and beneficiaries. It also entails examining government efficiency and effectiveness in tracking and reporting on issue-specific expenditure and the effect and value added of expenditure towards achieving policy objectives.

Public environmental expenditure reviews (PEERs) and climate public expenditure and institutional reviews (CPEIRs) are tools several countries are using to assess and track expenditures. These reviews can be undertaken on a regular basis or institutionalized within the public financial management process to provide regular data to track expenditures. Some countries are moving from simply tracking quantity of expenditures to also tracking the quality of expenditures in terms of impacts and results. Generating information to track climate expenditures effectively and maintaining financial records in the system of national accounts can serve to build a robust climate financing framework. The latter can be instrumental in accessing global climate funds (see chapter 7 for further details).

PEERs and CPEIRs, combined with economic evaluations of the benefits of pro-poor environmental sustainability and the costs of environmental unsustainability, have proven to be very effective in influencing ministries of finance to attach a higher priority to ENR, as the case studies in boxes [5.3](#) and [5.4](#) highlight.



Box 5.3 Economic Analysis of Natural Resources and PEER Gives Mozambique's Ministry of Finance Scope for Action

In 2012, Mozambique's Ministry for Coordination of Environmental Affairs, with PEI support, carried out an environmental economic analysis of natural resource management and a PEER (Mozambique Ministry for the Coordination of Environmental Affairs 2012a, 2012b). The assessments found that the equivalent of 17 per cent of GDP is lost each year due to environmental degradation and the inefficient use of natural resources. Nine per cent of GDP is the estimated cost needed to remediate these damages; the average environmental expenditure for the period 2007–2010 was 1.4 per cent of GDP.

"While the expenditure level

Source: PEI Africa.

shows that Mozambique is investing in sustainability, it also shows that more effort is needed," noted Reinaldo Mendiante, the ministry's Director of Planning. "Enhanced information on environmental expenditure is a first step towards improving investments in sustainability, as it will allow for more precise analysis. We are currently working with the sectors to design a strategy to improve the level of budgeting for sustainable development in Mozambique."

Strategic dissemination of assessment findings opened a window of opportunity to enhance the role of the Ministry of Finance in mainstreaming poverty-environment in Mozambique. The min-

istry promptly appointed two environmental focal points. With support from PEI, the ministry and the focal points are following up on one of the PEER's key recommendations: to enhance the use of environment and climate codes in budget processes. For the 2014 budget process, the ministry established a new budget classification code related to climate change. Also, the environment ministry has decided to test the feasibility of using a wider range of the available codes—including codes related to land management and physical and environmental planning—to better facilitate measuring progress towards achievement of development goals.



Box 5.4 Indonesia Issues Ministerial Decree on Budget Tagging for Climate Change

In July 2014, Indonesia's Ministry of Finance approved Decree No.136/2014 on Guidelines for Annual Planning and Budgeting of Line Ministry. The decree makes the Budget Tagging for Climate Change Mitigation system mandatory for seven line ministries (agriculture, energy, transport, industry, public works, forestry and environment) covered under the National Action Plan for Reducing Greenhouse Gas Emissions.

Source: Andria et al. 2014.

An online application and thematic budget coding system for tagging mitigation, adaptation and biodiversity activities and expenditures have been developed by the Directorate General of Budget, and two trainings have been conducted in its use. The first training was intended for the Ministry of Finance and to strengthen buy-in from the technical team of the Directorate General of Budget and the Fiscal Policy

Agency. The second was a technical training for representatives from the seven line ministries. The training was designed to anticipate the final budget consultation of line ministries for the 2015 fiscal year, when the tagging system is expected to be applied in the budget. To ensure a higher level of buy-in, the minister of finance also held a meeting with the seven line ministries in November 2014.

5.5 Mainstreaming into Fiscal Policy: Environmental Fiscal Reforms and incentives for Private Investment

In addition to determining government expenditures, the budget process also sets out fiscal policy to collect government revenues. This fiscal policy sets the incentive framework within which the private sector makes its investment decisions, such as the impact of energy taxes and subsidies on renewable energy investments, or the impact of forestry taxes and subsidies on levels of afforestation and deforestation.

Fiscal policy is a crucial aspect of public policy and can be used to combine the environmental and pro-poor outcomes that are central to a green economy (OECD 2005; World Bank 2005). Environmental fiscal reform (EFR) may not always be the most effective way to raise revenues, nor is it necessarily the best approach to protecting the environment. However, the value of EFR lies in its ability to simultaneously raise revenues and protect the environment. Examples are the removal of “negative” subsidies (e.g. on extractive natural resource technologies, fossil fuels or land degradation), imposition of environmental taxes or charges (e.g. on natural resource extraction, energy use or air and water pollution) and the introduction of “positive” subsidies (e.g. on renewable energy or energy-efficient technology)—although the latter will not raise revenues ([box 5.5](#)). The first two examples—removal of negative subsidies and the introduction of environmental taxes or charges—will raise revenues and thus increase the “fiscal space” for other types of expenditure. The introduction of positive subsidies (e.g. for renewables) will require revenues, so they must be looked at carefully—and consequently are prone to reduction or removal in times of fiscal constraint, as has been seen in some OECD

Box 5.5 EFR Results and Benefits in China and Brazil



China sets levies (taxes) on over 200 different air and water pollutants. In 2004, more than \$1.2 billion was realized from these levies, and used to fund environmental protection. Because pollution has continued to worsen in many areas, the Chinese government is now taking steps to increase charges on inputs such as energy to reduce the resulting pollution. In Brazil, the government has used value-added tax (VAT) revenues to reward states for creating protected areas. It is estimated that \$170 million has been generated in Parana over 14 years, increasing the number of protected areas in that state by 158 per cent. Across all of Brazil, these revenues totalled \$200 billion in 2009. However, while the fiscal benefits of these schemes have been easy to quantify in both China and Brazil, their environmental benefits have not been as clear, and insufficient attention has been given to identifying the link between fiscal revenues and environmental outcomes.

Source: GIZ 2013.

countries, which reduced their renewable subsidies during the recent recession.

EFR can contribute to poverty reduction by ensuring that poor households benefit from the revenues so raised (through use of higher revenue to increase service delivery of water and energy or other environmental improvements) and by environmental health gains from reduced pollution. In some cases, poor people could be affected by the price increases associated with EFR. This impact can be mitigated by ensuring that poor groups benefit from targeted subsidies or by reducing the prices of other goods and services to offset the EFR-related price increases. [Box 5.6](#) presents a relevant example dealing with fossil fuel subsidies.

Box 5.6 Safeguarding the Poor While Removing Fossil Fuel Subsidies

Global fossil fuel subsidies equalled \$409 million in 2010. In the simplest form of fossil fuel subsidy, government subsidizes the cost of fuel to make it more affordable for consumers and producers of fossil fuel products. Subsidies are a very inefficient way of reducing poverty—only 8 per cent of the fossil fuel subsidies in 2010 benefited the poorest 20 per cent of the population. These subsidies are very expen-

sive: in countries such as Indonesia and Yemen the total cost to the national budget exceeds that of the health and education budget combined. Moreover, eliminating these subsidies could reduce global fossil fuel emissions by 7 per cent. So how can reform occur?

The different types of fossil fuels are not used equally by consumer category—the poor use much

more kerosene, which means that targeted subsidies can be pro-poor. Also, the savings from subsidy elimination can be invested in targeted pro-poor expenditures. Ghana used subsidy savings to reduce school fees, while Jordan introduced a direct cash transfer to poor households and increased the minimum wage. These examples show it is possible to safeguard the poor while removing fossil fuel subsidies.

Source: PEP 2012.

EFR design will depend on country context and the ability of proponents to build coalitions for reform. The fiscal reform process includes not only the underlying social and cultural context (e.g. a view that water is a “free” good), but also specific challenges and opportunities that might arise. For instance, during a fiscal crisis, a window for far-reaching wider fiscal reforms which can include EFR could be created; a significant environmental disaster could act as a spur to environmental reforms including EFR. Building coalitions during EFR design depends on assessing the primary winners and losers from any fiscal reform and managing perceptions to ensure that the losers are compensated (often by using the revenues from the fiscal measures themselves) or that public opinion clearly holds that any such losses are “fair.”

Players involved in the reform process include the politicians, the government bureaucracy, the affected private sector and household consumers, especially poor households. Within these groups, there are further subdivisions, such as the different ministries within the

government or different groupings within the private sector.

Using the revenues as compensation to the affected industry, consumers or poor households may be important for political acceptability but may also create trade-offs by reducing the environmental and fiscal benefits of a reform. Dialogue is important, but vested interests may resist change, making leadership critical. The exact aspects of design will vary significantly depending on the kind of fiscal instrument:

- ✿ For subsidy removal and taxes on natural resource extraction (e.g. fossil fuel mining, industrial fishing fleets, commercial timber processing), powerful industrial players might resist reforms. However, the general public can likely be persuaded that such reforms are fair.
- ✿ Subsidy removal or taxes on fossil fuel energy prices may negatively affect many middle-class consumers as well as some



poor consumers and inflation; compensatory measures will be needed.

- Positive subsidies such as for renewable energy will be less controversial, although they may face challenges during a period of fiscal restraint.

The poor have typically benefited where there has been a clear commitment to use the revenues from EFR to benefit or compensate poor households. This has particularly been the case for fossil fuel price changes where poor households have been seen as an important political constituency to achieve reform.

5.6 Bringing It All Together: Developing a Climate Fiscal Framework

As climate change is becoming a major political and economic issue, there is growing interest in using fiscal policies to generate motivating forces for investments in low-emission and climate-resilient economies while dissuading investments in and use of high-emission technologies. The implementation of a climate-responsive medium-term fiscal framework should be part of the development of the medium-term budget strategy aimed at mitigating climate change; promoting a climate-resilient economy; and incentivizing climate-compatible, low-carbon economic growth (box 5.7). Following are the main features of such a framework and the steps entailed in developing it (Palmer et al. 2014).

Revenues

On the public revenues side, the ministry of finance should develop a climate-compatible fiscal policy, as well as a domestic and international resource mobilization strategy, to feed into the medium-term fiscal framework in

Box 5.7 Developing a Climate Fiscal Framework in Bangladesh



Bangladesh's Ministry of Finance has expanded its role in preparing a climate-responsive budget. First the government reviewed its expenditure on climate change, which was found to be \$1 billion per year, with three-quarters originating from domestic resources. While this amount was more than expected, there remains a financing gap to enable Bangladesh to be climate resilient. This motivated the Ministry of Finance to develop a climate fiscal framework that was approved by the minister of finance. The ministry has also now chosen to take the lead on government efforts to leverage international finance to meet the financing gap for climate change adaptation and mitigation. The Economic Relations Department of the finance ministry is now the national designated authority for the Green Climate Fund.

Source: PEI Asia-Pacific.

line with its overall fiscal discipline objectives (budget neutrality, etc.). Developing this policy requires technical support from the national revenue commission, the ministry of environment and relevant line ministries. Key steps include the following:

1. Measure the current share of domestic revenues allocated to climate relevant actions using the CPEIR expenditure analysis tool. This looks at how that share is expected to evolve according to the medium-term macroeconomic framework and/or any existing medium term climate finance targets which have been established by the government.
2. Review and reform pricing, taxation and subsidy policies to be climate compatible, and quantify their net impact on the budget.

3. Estimate the amount of funding expected from dedicated global funds—e.g. the Adaptation Fund, the GEF, the Least Developed Countries Fund (LDCF), the Green Climate Fund (GCF), the Strategic Program for Climate Resilience (SPCR) and the UN's Reduced Emissions from Deforestation and Forest Degradation (UN-REDD) Programme—and private finance, and include it in the medium-term revenue framework.
4. Estimate the expected level of funding from international (official development assistance) sources by consulting donors about their future intentions; integrate this estimate into the medium-term revenue framework.
5. Review methodological options for linking domestic sources of funds to their application in climate response. It should not necessarily be assumed that sums raised from fiscally based green actions will be committed to climate response; instead, a range of technical and policy linkages between the sources and applications of funds should be considered. This could include a virtual fund comprising international and domestic sources, ring-fencing of sums raised from taxation measures, budget support or a policy-based linkage. A full range of climate finance management options should be identified, noting the pros and cons specific to the context.

Once these steps are completed, a medium-term revenue framework can be developed that identifies which revenue streams are linked to a climate response. This framework provides the basis for deriving the climate resource ceilings for each line ministry, based on climate risk assessments and past expenditure trends in a given sector.

Expenditures

On the public expenditure side, line ministries need to develop climate-responsive

medium-term expenditure frameworks, within the set ceiling, to be submitted to the central agencies for approval and integration into the medium-term fiscal framework. Planning and budgeting for expenditures involves the following steps:

1. Identify programmes and expenditures that have a climate dimension (mitigation, adaptation, technology transfer and capacity building), using the CPEIR analysis but also, importantly, drawing on institutional knowledge and expertise.
2. Determine the climate relevance of programmes/expenditures, ideally using a benefits approach, or alternatively through expert judgment based on expenditure description with the provision of climate finance and public finance expertise.
3. Identify which climate-relevant programmes/expenditures need up-scaling or modification in their design (such as climate proofing) in order to optimize the benefits from the investment. The line ministry should also decide whether there is a need for new climate-dedicated programmes/expenditures.
4. Prioritize and phase programmes. This includes understanding net economic, environmental and social costs and benefits; and should take into account cross-sectoral linkages and complementarity of actions using various planning and appraisal tools, including:
 - Project appraisal including cost-benefit analysis, benefit-cost ratios
 - Marginal abatement costs and benefits for mitigation/adaptation effectiveness
 - The level of uncertainty or risk inherent in the action—a main source will be uncertainty about the severity and geographical as well as temporal extent of



climate change and what this implies for the performance of the climate actions considered

- Scoring and multicriteria analysis looking at environment, economic growth, poverty, gender and disaster co-benefits
 - Participatory approaches
5. Under the leadership of the central agencies, define key performance indicators and, where possible, provide evidence of baseline values and targets for monitoring the line ministry's climate change strategic plan. This information should be based on the selection of indicators already identified for possible inclusion in the national development plan.

Quick Reference Checklist:

Mainstreaming into Budget Processes

Engaging in the budgeting process

- Has the government integrated poverty-environment objectives into the three primary steps of the budget process?
 - ✓ Budget planning and formulation
 - ✓ Budget execution and implementation
 - ✓ Budget monitoring and oversight

Mainstreaming into the budget formulation process

- Has the ministry of finance included environmental and/or climate sustainability as a priority for public expenditure in its budget call to line ministries?
- Have projects undergone some form of screening to assess their costs and benefits?
- Have line agencies provided prioritized and costed programmes on the environment and climate change in submitting their expenditure plans to the ministry of finance?

Mainstreaming into the budget execution process

- Are actual expenditures below the planned expenditures contributing to low delivery rates by the ministries? If yes:

- ✓ Do sectors have the capacity to deliver on work in areas outside their traditional scope, such as environmental sustainability, climate change and gender?

- Have budgets been delivered to line ministries on time, as some environmental expenditures (e.g. afforestation) may be time sensitive?

Mainstreaming into budget monitoring and oversight

- Is the government tracking its expenditures on environment and climate through PEERs and CPEIRs?
- Is the government tracking the quality of expenditures in terms of impacts, in addition to tracking the quantity?

Mainstreaming into fiscal policy

- Has the government introduced EFRs to raise revenues and protect the environment through the following:
 - ✓ Removal of negative subsidies
 - ✓ Imposition of taxes or charges
 - ✓ Introduction of positive subsidies
- Has the government taken into consideration the country context and the ability of proponents to build coalitions for reform in EFR design?
- Can the government be supported to develop a climate fiscal framework which takes a holistic approach to expenditure and revenue policy and its interface with climate change?



