6. Climate finance

The main idea behind REDD+ is that developed countries can offset their emissions by paying developing countries and project developers for reducing emissions from deforestation and forest degradation. A wide array of arrangements is emerging to manage donor pledges (WRI 2010) or developing countries' own forest- and climate-related funding allocations.

One of the main questions in both international and national discussions on REDD+ finance today is how the finance can be effectively delivered to and within countries. The main concerns are that REDD+ finance will not be coordinated, not owned by the respective national governments and not aligned with national governments' systems (Brown and Peskett 2011). Other concerns are that REDD+ finance will focus exclusively on the design, implementation and monitoring of REDD+ without paying attention to such underlying conditions for success as tenure security, the presence of institutions in forest areas to absorb carbon payments and governance reform to combat corruption (Macqueen 2010).

In Indonesia, REDD+ funding mechanisms are evolving to support the readiness phase in terms of policy and institutional development as well as on-the-ground investment in REDD+ demonstration projects. With significant donor support already pledged to Indonesia, it is important to understand the potential bottlenecks and risks of misuse and corruption and learn from experience in forest finance or from more recent efforts in climate finance. Currently, grand corruption may shape the way in which financing mechanisms work and ensure that special interests have access to REDD+ finance. It may also create loopholes, which may later allow for both grand and petty corruption, when the mechanism is tied to a carbon market and performance in reducing emissions.

6.1 Climate finance in Indonesia

Indonesia is one of the first countries to be building institutions to manage and distribute climate finance. Much of this finance is associated with donor funding or soft loans. Climate funds in Indonesia include the Climate Change Program Loan (CCPL), the Indonesia Climate Change Trust Fund (ICCTF) and the Indonesia Green Investment Fund (IGIF), as well as direct project and programme support. Of these, the CCPL, ICCTF and IGIF, which operate at national level, coordinate, or aim to coordinate, financing from various sources.

The CCPL is managed by the Ministry of Finance and is part of the general budget allocations. The CCPL is a concessional loan financed by Japan (Japan International Cooperation Agency; JICA) and France (Agence Française de Développement; AFD) since 2008, with the World Bank joining in 2010, to support the GoI's efforts to develop a lower-carbon, more climate-resilient growth path. It allows the GoI to reduce the fiscal deficits of the agencies (recipients of the loan) and presumably creates incentives to adhere to climate policies already planned. A Steering Committee and Joint Monitoring Meeting review respective agencies'/loan recipients' progress in implementing policies (Brown and Peskett 2011). In this way, the CCPL supplements regular agency budgets; it is unclear how and to what extent it directly supports emission reductions in forestry.

The aim of the ICCTF is 'to contribute effectively and efficiently to mainstreaming climate change issues in government planning and the implementation of climate change activities across Indonesia'. The ICCTF was created by Bappenas as a national managed trust fund with 3 funding windows: energy; forestry and peatlands; and adaptation and resilience. Its objectives are to increase the GoI's effectiveness in achieving Indonesia's goals of a low-carbon economy and better resilience and adaptation to climate change. In September 2009, the UN Development Programme (UNDP) was appointed to administer the ICCTF on an interim basis. ICCTF management includes a Steering Committee composed of donors and development partners, a technical committee and a secretariat. A GoI Ministerial Steering Committee provides policy guidance. Three donors currently contribute to it: UKaid, AusAID and Norway (see www.icctf.org and http://www.undp.or.id). This may represent an early step in improving coordination of donor climate funds to Indonesia, although most of the donors already involved do not channel their funds through the ICCTF.

The plan to establish the IGIF, a new national climate fund, was announced by President Yudhoyono in Copenhagen in 2009. The IGIF aims to catalyse infrastructure development that could speed up economic growth, boost food and clean water production and help cut GHG emissions. Indonesia's Government Investment Unit has allocated US$400 million into the fund, with a further US$900 million expected from donor governments and institutional investors (Jakarta Globe 2010a; Brown and Peskett 2011). The AFD, UKaid, JICA, Korea and the Islamic Development Bank have expressed an interest in contributing to the fund but the amounts are not yet clear. IGIF financing will comprise a blend of grants, concessional loans and equity to develop low-carbon business models at scale, primarily in energy and sustainable land use. The idea is to blend private and public – and national and international – financial resources for climate mitigation. IGIF is not a fund *per se* but an association of individual accounts managed by contributors using different rules but at the same intermediary bank (Brown and Peskett 2011).

6.2 Experience with management and distribution of forest funds in Indonesia

The potential effectiveness of public funding for climate change mitigation in Indonesia is likely to be influenced by the ability of existing and new institutions to address a number of challenges, one of which is the prevention of corruption or mismanagement of REDD+ funds. Past experience with forest finance and forest funds can provide lessons for REDD+ finance in Indonesia.

The current forest revenue distribution system is regulated by Law No. 33/2004 on revenue sharing between the central government and the regions, and its implementing regulations stipulate that revenues be shared across levels of government. The share received by each level of government differs according to the revenue source, as does their eligibility. Approval and disbursement involves the MoF, the Ministry of Finance and, in some cases, the Ministry of Home Affairs (Figure 1).

Any mechanism for the distribution of REDD+ revenues is likely to be different because it will distribute revenues amongst government departments, developers and communities, not just amongst different levels of government. Decisions on who will receive and manage revenues have not yet been made, and it is unclear how a future system would operate. However, a REDD+ payment mechanism may have similarities with the current forest revenue distribution system because it will need to work across scales, distribute different shares of the revenue amongst entities, establish eligibility criteria and define approval and disbursement processes.

The disbursement and management of revenues across scales present several challenges. One is delays in disbursement and spending – a frequent problem in the distribution of large funds when financial management capacity is poor (Subarudi and Dwiprabowo 2007). Delays in disbursement in turn cause delays in implementation of subnational governments' development programmes. To avoid delays, provincial and district governments either directly lobby the MoF and Ministry of Finance, or indirectly lobby the national members of parliament who represent their respective regions (Resosudarmo *et al.* 2006). The approval and allocation process also involves a lot of back and forth amongst districts, provinces and central agencies, which causes further delays.

Revenues from the Forest Concession Fee (IHPH) and Forest Resource Rent Provision (PSDH) are transferred into an MoF bank account; from this account, revenues are further distributed to local level. At province and district levels, the funds are integrated into the provincial and district budgets, which means that the revenues may or may not be used for forest-related activities. In many cases, the shared forestry revenues are insufficient to cover the budget of provincial or district forestry offices (Dermawan 2004).

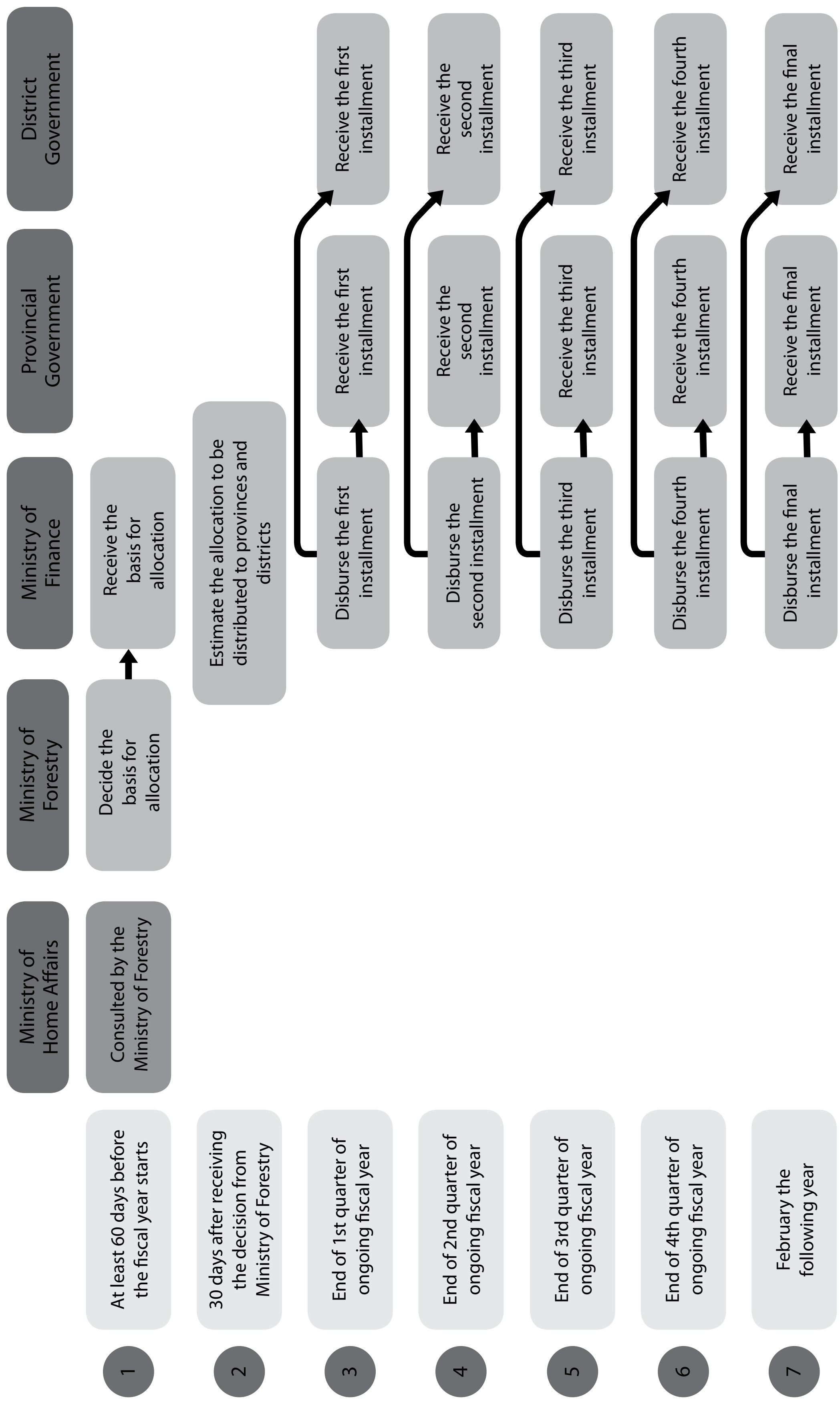

Figure 1. Allocation and distribution of forest revenues

Source: Government Regulation No. 55/2005; Ministry of Finance 2010.

However, perhaps the most important challenge is how the government uses the revenues. Media reports and BPK audits for some provinces that were recipients of the DR indicate that, even though some DR funds were earmarked for certain projects, they were frequently diverted to ineligible activities or to non-existent projects. Although the DR was intended to promote reforestation and forest rehabilitation, it was used by the Soeharto regime to finance politically favoured projects and allowed politically connected or family networks to capture large transfer rents. The transfer of the DR to the Ministry of Finance and its integration into the state budget in 1998–1999 introduced important checks and balances but some weaknesses remained, such as disbursement problems, inability to manage funds effectively (especially by provincial and district governments), weak internal controls and poor reporting (Barr *et al.* 2010). Two agencies – the BPK and the KPK – have played significant roles in improving the transparency and accountability of the DR fund and reducing risks of corruption. The BPK has identified weaknesses and steps for improvement in its numerous audits of the DR. The KPK has successfully prosecuted high-profile DR corruption cases (Barr *et al.* 2010). However, poor financial management, accountability, transparency and capacity persist, and many of the officials and the powerful politically connected groups that directly benefited have gone unpunished (BPK 2008).

6.3 The role of banks in the Reforestation Fund

The relationship between the MoF and the intermediary banks may partly explain the DR's poor performance in achieving its stated objectives and offer a lesson for REDD+. One reason banks failed to support the appropriate use of the DR was the contradictory, unclear lines of authority. A 2008 audit report noted that the banks had generally failed to enforce conditions on defaulted loans from the DR (BPK 2008). The MoF expected the banks to enforce the conditions of the loans, but the banks maintained that they could do so only after authorisation by the MoF. Another reason for the banks' failure may have been the lack of incentives to call in the loans and enforce contracts; in fact, they had incentives not to. They received a percentage of the money disbursed from the DR, but paid-off debts reduced this percentage. Therefore, they had financial incentives to disburse

Box 3. The Reforestation Fund

The introduction of the Reforestation Fund (Dana Reboisasi; DR) and subsequent increases in the fee rate, triggered a substantial increase in the state's capture of timber rents. During the final decade of the Soeharto era, the government of Indonesia collected approximately US$2.6 billion in nominal receipts to the Reforestation Fund, whilst interest accrued on the principal amounted to an additional US$1 billion. On an annual basis, DR receipts and interest during the last 5 fiscal years of the New Order period ranged from US$395 million in 1997/8 to US$540 million in 1995/6.

During the Soeharto era, the Ministry of Forestry used the DR to promote the development of industrial timber and pulpwood plantations, allocating more than US$1 billion in cash grants and discounted loans to commercial plantation companies. The ministry distributed a substantial portion of the DR funds and forest conversion licences to companies with close ties to state elites, allowing a few well-connected actors to capture sizeable forest rents. Ten companies, all directly connected to the Soeharto regime by either family or political ties, received US$635 million, or about two-thirds of the DR funds allocated for timber plantation development. In addition, the ministry disbursed US$600 million to finance politically favoured projects that had little to do with the DR's mandate of promoting reforestation and forest rehabilitation.

DR subsidies for developing plantations encouraged overharvesting of logging concessions and clearing of 'degraded' natural forests. Timber companies had a strong incentive to mismanage the forests in their concession sites so that they would be eligible for subsidies to convert these areas to timber or pulpwood plantations. The current administration is using DR funds to promote the development of 9 million ha of new plantations by 2016 to 'revitalise' the nation's commercial forestry sector.

Source: Barr *et al.* (2010)

the funds but not to call in the loans or enforce them (Barr *et al.* 2010).

Selecting an appropriate intermediary bank is an important step in ensuring efficiency in management of funds. A 2008 analysis showed that the Indonesian banks most efficient in managing funds were the large 'state-owned' banks, and the least efficient were 'regional government–owned' banks (Hadad *et al.* 2008). However, as the DR example shows, even large, efficient Indonesian banks cannot enforce contracts or prevent misuse if their relationship with the government is not adequately structured.

6.4 Learning from finance in forestry, climate and the environment

Of the numerous initiatives aiming to protect tropical forests in the context of climate change, 16 are funds that manage or have been pledged more than or close to US$50 million (Macqueen 2010). Of these, 7 major bilateral and multilateral funding initiatives have been created explicitly to fund REDD+ (Caravani *et al.* 2010). Most of the large, donor-pledged, multilateral REDD+ funds are managed by the World Bank or other regional development banks, the Global Environment Facility or UN agencies such as the UNDP and FAO (Food and Agriculture Organization). Other funds, such as the Global Climate Change Alliance (GCCA) or the Hatoyama Initiative (HI), are managed by the respective developed-country governments. Only 1 country-level climate fund operates outside of Indonesia – the Amazon Fund (FA), which is administered by the Brazilian Development Bank (BNDES) and involves the Amazon Fund Guidance Committee (COFA), a 3-block committee composed of state government, federal government and civil society representatives (Macqueen 2010).

The number of REDD+ funds is growing rapidly. Most have been established since 2007; they tend to be forestry sector-driven, government channelled, often controlled by a governmental or intergovernmental organisation (such as the UNDP) and self-monitored. Their approach is to reduce transaction costs and to compensate financial opportunity costs for keeping the forests standing (Macqueen 2010). Many of the existing funds coordinate the support from donors. In many ways, however, they fail to or only partly address other important concerns – ownership by recipient governments or tenure security, building institutions in forest areas to absorb carbon payments and reforming governance to combat corruption (Macqueen 2010, Brown and Peskett 2011).

Other past initiatives that may provide useful lessons for REDD+ are debt-for-nature swaps. Similarly to how REDD+ is currently developing in Indonesia, debt-for-nature swaps are bilateral arrangements between developed and developing countries. In the 1990s, debt-for-nature swaps were considered a new strategy to control the exploitation of natural resources, including forests, without ignoring the economic needs of developing nations. By 2000, more than US$1.5 billion in transactions had been exchanged in debt-for-nature or debt-for-environment swaps amongst more than 19 countries (Thapa 2000).

Even though debt-for-nature swaps are fundamentally different from a REDD+ scheme – as the former are linked to growing debt in developing countries – the 2 mechanisms do have similarities and shared objectives. Very much like REDD+, debt-for-nature swaps aim to reduce the exploitation of natural resources – forests in the case of REDD+. As in REDD+, several actors are involved in each debt-for-nature swap – the government of the indebted country, a donor (government or private), a bank and, in many cases, an international and a national NGO.

Debt-for-nature swaps provide several relevant lessons for REDD+. With few exceptions, most swaps occurred in forest- and biodiversity-rich developing countries, characterised by weak enforcement of legal claims to environmental resources, high costs for delineating and monitoring environmental outcomes and nominal government ownership of the resources involved (Deacon and Murphy 1997). Their success required local involvement and support by communities, as well as programmes to build local capacity to implement projects as part of the financing under the swaps. Swap projects also demonstrated the difficulty and costs associated with monitoring outcomes.

6.5 Risks related to REDD+ finance

As current experience with climate finance in Indonesia and globally indicates, efforts are being made to address issues related to donor coordination. However, experience with forest, environment and climate finance and debt-for-nature swaps, as well as emerging climate finance schemes in Indonesia, indicates several outstanding issues also.

Most emerging or existing climate finance arrangements fail to fully address concerns about ownership by a recipient country and alignment with national governance systems. There seems to be little understanding of the financing needs for effective climate change mitigation actions (Brown and Peskett 2011). The high costs of monitoring environmental outcomes and weak enforcement and ownership arrangements, as demonstrated by debt-for-nature swaps, require up-front investment in governance beyond the preparation for REDD+. However, currently no or little attention is being paid to address issues related to the clarification of state and community forest boundaries and to building the capacity of subnational forest-related institutions. Failure to attend to these issues could threaten the effectiveness of REDD+ donor funding as well as the equity and effectiveness of REDD+ in the future. Further, most existing funds are self-monitored and do not have built-in plans for independent audits or oversight. Given past experience in Indonesia, the absence of independent financial monitoring and investment in capacity for financial management clearly heightens the risk that REDD+ funds will be misused.

These various weaknesses create risks of corruption and mismanagement of climate finance in several ways. Past problems with the effectiveness of donor financing may be replicated. The underlying causes of mismanagement, such as capacity of government and local institutions, may not be adequately addressed. Well-connected international and national networks may receive the greatest benefits. Or the climate finance may have no effect on reducing carbon emissions from forests because the funds are used for purposes other than that for which they were intended.

As international and Indonesian experience indicates, several steps can be taken to reduce these risks and address current weaknesses. National institutions entrusted with fighting corruption and money laundering such as the KPK, PPATK and BPK should be involved in creating checks and balances and ensuring financial and other monitoring of climate funds as well as of the people and organisations associated with or benefiting from them. Attention should also be paid to processes to ensure all agencies involved in managing and disbursing funds or in enforcing conditions are held accountable. Independent oversight and public information disclosure are likely to mitigate the risks of corruption in REDD+ finance. The capacity of the national government and especially of local institutions should be boosted so that they can effectively and appropriately manage, account for, disburse in a timely manner and/or use REDD+ funds. The government's relationship with intermediary banks should be structured to avoid mismanagement. In addition, as debt-for-nature swaps and many existing climate finance arrangements suggest, local ownership is also critical for success.