IFAD BRIEFING NOTE

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Climate Finance

Scaling Investments in Climate Smart Agriculture

SKD Learning Notes bring lessons learned through the interaction of data, operations and evidence, and benefit from the advice of the Knowledge Unit.

Context

Small-scale farmers account for the majority of food production across Asia and sub-Saharan Africa, accounting for up to 50 per cent of employment and 15 per cent of gross domestic product (GDP) in SSA and Asia. Despite the importance of small-scale agriculture to the global economy and its vulnerability to climate change, the sector does not receive sufficient funding. The share of climate finance directed to small-scale agriculture is small: only US$10 billion in 2017/18. To put this into perspective, the funding needs of small-scale farmers are estimated at US$340 billion, resulting in an annual funding gap of US$330 billion[1]. With this financing gap set to grow over the medium-term, small-scale agriculture needs to look for new sources of finance. Given the economic climate across the globe, many governments are faced with limited domestic tax revenue options. The public sector will, therefore, no longer be the driver for finance for climate- smart small-scale agriculture.

Proposition

Climate-smart small-scale agriculture can be funded and managed through fiscal and financial instruments[2]. This Learning Note provides a summary of the instruments that can be implemented by the public sector. The overall focus is on using limited public funds more efficiently and amplifying impacts.

Lessons from the health and education sectors are used to provide insights into how to deal with high-priority policy goals, given the tight fiscal space. The proposals are based on instruments that have been used successfully across the globe in social sectors, as well as those that are developing specifically for climate and agriculture.

[1] UNEP. 2021. Adaptation Gap Report 2021. Nairobi: United Nations Environment Programme.
[2] World Bank. 2021. Climate-Smart Agriculture. World Bank, 5 April. https://www.worldbank.org/en/topic/climate-smart-agriculture

Earmarked Taxes

The process of reforming and raising general taxes can be a lengthy process. However, setting up earmarked taxes can be quicker, and can cover niche financing needs[3]. Legislation can be created to link earmarked revenues to certain sector spending, including private sector incentives – for example, sugar levies applied in Mexico and Philippines for health, or environmental taxes in Costa Rica[4]. When deciding which tax to implement, different earmarked instruments have different impacts to consider, such as sustainability, economic side effects, and the public or political appetite for new/increased taxes.

Public Guarantees

Public guarantees are a way to transfer and diversify risk and enable access to capital in underserved areas. A government (or public development bank) guarantee of covering losses makes a previously risky investment opportunity more attractive and secure, and can attract new investment. The outlay for governments is not large, because guarantees pay out in case of loss rather than for the full capital needs. One example of success can be found in the creation of the National Guarantee Fund for Agricultural, Forestry, Fisheries and Rural Sectors ("Green FONAGA") by the National Development Bank of Mexico[5]. However, due to their complexity, there are certain actions to be taken to make them successful, such as governments ensuring equal access and safety, strong contract management, and convincing investors that they will cover losses.

Weather-indexed insurance

Developing low-cost insurance products or offering subsidies for weather-indexed insurance can increase investment in climate-smart small-scale agriculture by reducing risk. Such insurance can also improve the stability of farmers' income, as investments can be made knowing that if adverse weather occurs, a payment will be made, allowing an investment loan to be repaid and the welfare of the farming household to be maintained[6]. Successful examples include Pula in sub-Saharan Africa and the Caribbean Catastrophe Risk Insurance Facility (CCRIF) [7]. However, in general, voluntary uptake remains low, as there is apprehension among farmers and potential investors alike. Factors to help overcome problems in developing and implementing successful weather-indexed insurance include reliability of data[8], and well-defined regulatory/legislative/contract management from the outset [9]. Insurance needs to be subsidized to raise voluntary membership[10], and there must be time to market the product to achieve effective uptake and sales.

Results-based financing

A mix of public, private, household and philanthropic funding and fees can be used to de-risk the investment. Results-based financing aims to tackle spending inefficiencies and refers to a "program or intervention that provides rewards to individuals or institutions after agreed-upon results are achieved and verified"[11]. Examples of success have been seen in delivering Early Childhood Development needs using Social Impact Bonds within in a results-based payments system, and vaccine procurement by UNICEF and others[12]. Another example is the Financing Ghana Agriculture Project (FinGAP) which resulted in the development and implementation of new financing products for agriculture[13].

[3] IMF. 2007. Manual on Fiscal Transparency. Washington, D.C.: International Monetary Fund.
[4]BMJ. 2020. Mexico's Sugary Drinks Tax has Helped Cut Consumption After Just Three Years. British Medical Journal, 6 May.
[5]Pula. 2022. Pula website. https://www.pula-advisors.com/
[6] Kramer, B. 2019. Can Weather Index Insurance Help Farmers Adapt to Climate Change? IFPRI Blog, 13 December. https://www.ifpri.org/blog/can-weather-index-insurance-help-farmers-adapt-climate-change
[7] https://www.pula-advisors.com/ and https://www.ccrif.org/?language_content_entity=en.
[8] World Bank. 2011. Weather Index Insurance For Agriculture: Guidance for Development Practitioners. Agriculture and Rural Development Discussion Paper No. 66274. Washington, D.C.: World Bank.
[9] Kramer (2019).
[10] World Bank (2011)
.[11] World Bank. 2022. Results-Based Financing (RBF) and Results in Education for All Children (REACH). World Bank.
[12]Chen, J. 2022. Social Impact Bond (SIB). Investopedia, 12 April. https://www.investopedia.com/terms/s/social-impact-bond.asp
[13]Palladium. 2019. Transforming the Agrifinance Market System in Ghana: Positive Impact Case Study. Palladium. https://thepalladiumgroup.com/news/Transforming-the-Agrifinance-Market-System-in-Ghana

Elements to consider when evaluating the effectiveness of design and implementation of results-based financing are as follows:

- Results-based financing has been used well to deliver services in remote areas or to hard-to-reach portions of the population. This fits well with finance for small-scale agriculture as an underserved area.
- Results-based contracts can finance implementation of new, alternative methods for delivery to these areas or populations and provide a reduced risk environment to try out adaptive approaches and innovations.
- However, there is an appropriate level of uncertainty required for success in these types of projects. Scaling up proven interventions is not always suitable for results-based financing, and neither is an untested theory (i.e. a pilot should have been carried out to ensure this method will be successful). There is a middle ground of uncertainty that suits this financing instrument, where there is evidence that something may work, but it is still too risky for government investment, so use investors and risk their money.
- The measures for success and payments should be set against strong monitoring and evaluation (M&E) for social outcomes, not infrastructure outcomes – for example, 20 per cent more girls retained in education.

Establishment of a national climate fund

A national climate fund streamlines financing to projects with a focus on green growth. Projects can include activities around adaptation, mitigation, technology development and capacity-building.

Financial inputs to a fund can be pooled from multiple sources in the form of grants, loans or capital contributions. These sources can be external, such as multilateral finance institutions, development partners and international climate funds, or domestic, such as taxation (environmental levies or carbon taxes) or debt (green bonds). A successful climate fund, the National Green Fund (also known as FONERWA), has been put in place in Rwanda [14]. Success factors include the following:

- To be productive, the impact of the loan must be greater than the cost of the debt. To assess the benefit, the government would need to undertake debt sustainability analysis and macroeconomic analysis to ensure the bond will be the best use of funds over time.
- Implementation of a well-functioning national climate fund requires a strong legal framework. A lack of regulation and government guidelines can be impediments.
- Development of an M&E and reporting framework. Key performance indicators that demonstrate green impact are required.

Actions to Create an Enabling Environment

- Macro-fiscal circumstances will determine the suitability of an innovative financing or fiscal instrument. A variety of criteria are required to be qualified before designing and implementing any instrument, including debt level, capacity to deploy and administer, legislative authority, and data and M&E systems. Authorities will need to improve contract management and M&E. Stakeholder coordination will need to be improved.

[14] FONERWA (2022) and Government of Rwanda (2022).

- First, all instruments require political support. Second, ministries of finance, planning, development and international cooperation are well-positioned to supervise innovative financing. Third, for optimal financing, the Ministry of Finance needs to assist in improving communication, information-sharing and dialogue through evidence and impact analysis for more effective policy design and implementation. Fourth, Public Development Banks are a new and growing area for climate finance. To ensure that policies are aligned with empirical evidence and the needs of small-scale farmers, agricultural investment and investors, other ministries, departments and agencies should work collaboratively with the ministries of finance, planning, development and international cooperation, and the investment promotion agency.

- This can create an enabling environment in which experts in climate-smart small-scale agriculture work together with finance and investment experts in agencies such as public development banks and investment promotion authorities, as well as international stakeholders.

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