Accelerating Transfers of Interim Finance for REDD+: **Building Absorptive Capacity**

A report for UK DFID

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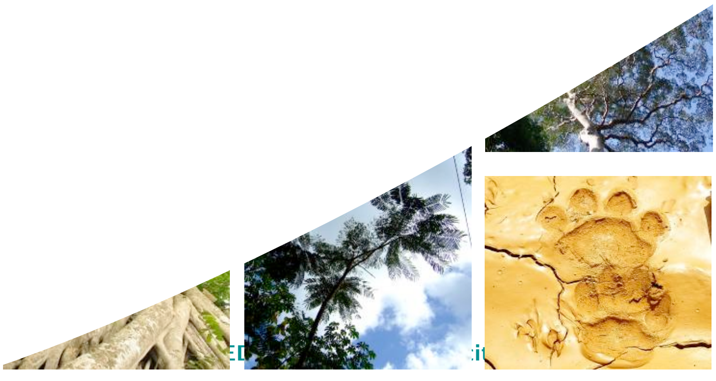

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Summary

The objective of interim finance for REDD+[1] is to reduce emissions and enhance removals of greenhouse gases in relation to forests in the shortest possible timeframe. Therefore, interim finance for REDD+ will only be useful if it can be used efficiently and effectively by Rainforest Nations to achieve this objective. This will be strongly influenced by the capacity of each country to acquire and use any available resources effectively, sometimes termed their absorptive capacity. This in turn has major implications for the design of an interim finance mechanism.

1. **Country-level capacity**: There are significant differences between the capacity of different Rainforest Nations to acquire and use financial resources for REDD+. While some are likely to be able to access funds from a variety of sources, whether public or private sector, relatively easily, others are much less able to do so. Similarly, there are significantly different levels of capacity to implement the measures required to achieve REDD+ (readiness). This means that some countries are likely to be able to move relatively quickly to a point where significant national-level emission reductions can be achieved while for others this will take much longer to achieve. This has two immediate implications for any financing mechanism:

   To be effective, the delivery mechanism for interim finance will need to be appropriate for significantly different country situations. This is likely to require a variety of delivery options rather than a single approach.

   Many Rainforest Nations are unlikely to be able to benefit from national-level performance-based payments (either as part of an interim finance mechanism or under a longer-term climate agreement) without a period of sustained and effective capacity building. This should therefore be a main pillar of any interim finance strategy.

2. **Multiple drivers**: A further complication is that there are many different drivers which contribute to forest degradation and loss each of which has its own institutions, actors, potential mitigation activities and incentive structures. Some drivers are highly subject to international leakage (eg agricultural commodities, industrial logging), while others are not (eg subsistence agriculture). Some mitigation activities are potentially economically viable in their own right (eg improved forest management) while others are not (eg reduced conversion for agriculture). Those involved in some drivers are well-organised with high levels of capacity to implement changes, while those involved in other drivers are disorganised and lack even basic capacity for implementation. Therefore, each driver requires different policies and measures and will need to involve a different suite of actors in successful mitigation.

[1] REDD+ is used to refer to the full suit of forest activities including not just reduced emissions from deforestation and degradation (REDD) but also conservation of existing stocks (SFM) and enhancement of removals (afforestation/reforestation).

To be effective, the delivery mechanism for interim finance will need to be designed to achieve effective engagement with the whole range of drivers and potential mitigation activities. This has a number of implications discussed below.

3. **Build on experience**: Efforts to reduce forest degradation and loss are not new. Many of the potential activities that will contribute to REDD+ (eg improved governance, better logging practices, increased efficiency of smallholder production, establishment of protected areas) are already being pursued in many countries. Some of these efforts have been successful, but many have not and though lack of financial incentives has been one of the causes, it is not the only one. Other factors, and particularly a lack of capacity, have also played an important role. The design of an interim finance mechanism needs to utilise this experience to avoid repeating failures and to build on successes.

   Current REDD+ efforts should build on the experience of what has and what has not worked in the past and the reasons behind this. A rapid, practical and comprehensive review for each major driver could provide an excellent basis to be used in designing the interim finance mechanism.

4. **Involve a wide range of actors**: In order to overcome capacity constraints as efficiently as possible, and to engage with the whole suite of stakeholders involved with the variety of drivers, a wide range of organisations should be involved in implementing REDD+. National governments have an important role to play in co-ordinating national strategy, but implementation of measures and programmes will need to involve, *inter alia*, local governments, non-profit organisations, the private sector, indigenous peoples and forest communities.

   Any finance mechanism for REDD+ should be designed to encourage the involvement of the widest possible range of organisations and stakeholder groups in implementing REDD+.

5. **Finance aimed at different scales**: Development and implementation of a national REDD+ strategy must be a cornerstone of the approach for any country. However, for many of the activities required to address particular drivers there are strong international links and it will also be important to have international programmes to encourage networking and collaboration (eg agricultural commodities). At the same time, particularly in countries where there are constraints to rapid progress at a national level, it is important to support activities at a local level which can help to build a critical mass of activities from the bottom up.

   REDD+ financing should be provided at a variety of scales. This should include national-level funding mechanisms, support for international programmes and mechanisms to fund local activities (potentially including performance-based payments for local projects or programmes prior to a national system being in place).

6. **Scale up capacity-building at all levels**: Lack of knowledge, understanding and capacity is likely to be a major barrier at many levels for many countries. There is

an urgent need to build capacity rapidly. There are already a variety of efforts to do this, including proactive approaches from the non-profit sector as well as governments and donors.

Training and capacity building should be a major and ongoing component of any interim REDD+ financing mechanism. This should ensure that emerging experience is shared as well as basic information, and is one of the activities where international programmes should run in parallel with national approaches.

7. **Innovation and leadership**: It is extremely unlikely that REDD+ will succeed simply by trying to scale up existing programmes and approaches. While this is important, there will also need to be new and innovative approaches if changes on the scale required are to be achieved. In general, innovation requires imaginative leadership and flexibility. While it is not possible to create leaders, it is crucial to support possible solutions as they emerge.

   The interim finance mechanism should include flexible provisions to encourage and support new and innovative approaches and avoid focusing only on existing approaches.

8. **Financing architecture**: The financing architecture can itself become a barrier to progress if it is inappropriate. Firstly, the capacity of institutions within the funding chain to disburse, as well as receive, funding is fundamental. In practice, however, many institutions, both governments and multilateral finance institutions can be very slow and bureaucratic. A realistic assessment needs to be made of the distributive capacity of any entity in the chain. Secondly, the transfer process for funds (application, screening, approval, monitoring etc) can be very onerous and discourage or discriminate against groups (or even countries) lacking capacity. This can be addressed by a focus on the level of materiality which requires the transfer process to be appropriate to the level of risk. For smaller sums, a focus on accountability and transparency of the recipient may be more appropriate than complex bureaucracy. Institutions able to use this approach need to be found and utilised.

   Interim REDD+ financing, particularly prior to payment based on national performance, should utilise a range of different institutions to ensure that finance can be efficiently and effectively supplied to a range of different end-users. In addition to multilateral and national development banks this could include private banks, non-governmental organisations and private sector organisations.

9. **Incentives for progress to performance-based payments**: It is clear that some countries will be able to move more quickly towards performance-based payments than others. It is very important that the funding mechanism is designed to provide support to the countries which progress more slowly. However, it may also be useful to consider incentive mechanisms to encourage countries to progress from cost-based to performance-based payments. One approach to doing this, if performance-based payments are made to individual

projects or programmes within a country, is to link the two. For example, there could be a link between the proportion of performance-based and cost-based funding provided with a gradual defined decrease in the proportion of cost-based funds. Alternatively, cost-based funding could be provided as a supplement attached to performance-based payments.

While it is essential to have adequate cost-based funding to support progress in countries with capacity constraints, it may be useful to provide incentives to progress to performance-based payments by linking the proportion of cost and performance based funding which is paid.

Background

In March 2009, a report commissioned by the Government of Norway (referred here as the 'Meridian Report'[2]) was published to contribute to the policy development process related to the inclusion of a mechanism for reducing emissions from deforestation and forest degradation (REDD) in a post-2012 regime under the UNFCCC (UN Framework Convention on Climate Change).

Using this report as a starting point, a series of practical implementation points have been identified that requires further work. In particular, two of the areas requiring greater attention are the issues of the absorptive capacity of the Rainforest Nations to utilise any additional funding raised, and the issue of opportunities for early market involvement[3]. This is one of two reports commissioned by the UK's Department for International Development (DFID) to provide further input on these topics[4].

1. Absorptive capacity

The main objective of interim financing for REDD+ is to begin achieving reductions in emissions and enhancements of removals of GHGs in relation to forests in a timeframe of months and years rather than decades. If this objective is to be achieved, then it is crucial not only to raise adequate financing but also to ensure that it can be effectively utilised.

There are numerous examples of similar attempts by the international community to raise and utilise finance in response to particular issues ranging from poverty alleviation to protection of biodiversity. In some cases this has been very successful, but there are many others examples where it has at best only partially succeeded and at worst failed entirely. There are many reasons for lack of success, but a key one, particularly where the recipient countries are poor (which is the case for many rainforest nations) has been a lack of absorptive capacity. Therefore, it is crucial to understand what implications this is likely to have for the success of interim financing for REDD+.

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[2] Angelsen A., Brown S., Loisel C., Peskett L., Streck C., and Zarin D., 2009. Reducing emissions from deforestation and forest degradation (REDD): An options assessment report. Prepared for The Government of Norway. Meridian Institute, March 2009.

[3] It is important to note that there are a number of other implementation issues which are equally important in achieving the objectives of interim finance for REDD+ including environmental and social issues, equity and resource tenure rights. These are being considered in a number of fora and are not the focus of this paper.

[4] The other report being: "Accelerating transfers of interim finance for REDD+: Options for early market involvement, by Moura Costa P. and Nussbaum R., ProForest report to DFID, August 2009."

The absorptive capacity of a country, an organisation, or a programme is its ability to receive and utilise resources. For financing for REDD+ there are two aspects of absorptive capacity which are important:

- The capacity to plan and implement activities: if there is no capacity to plan and undertake mitigation activities then, however much finance is available, nothing will happen.
- The ability to get available finance to potential end users: if finance does not move from the source of funding to the end users, they will be unable to undertake the activities for which the finance was intended.

For both interim and long term financing for REDD+ to be effective, both of these potential constraints to absorptive capacity must be understood and addressed. Each is discussed in more detail below.

In considering each of these two aspects it is also necessary to consider the implications of the main objective for interim financing – to achieve results quickly. To do this it is necessary to address both of these aspects in a way which is both efficient and effective. Efficiency is essential in order to act quickly. Any delay in disbursing and using funds will seriously undermine the objective. Effectiveness is essential in achieving results. It is not sufficient simply to disburse and use funds rapidly. It is also essential that they are used for activities which contribute to the objective of reducing emissions or enhancing removals of GHGs from forests.

In many cases there is likely to be a significant tension between efficiency and effectiveness. For example, it would be easy to establish a mechanism where funds could be very quickly disbursed and spent if there were minimal requirements on how it was used, but the application of such funds would be unlikely to generate very effective results. On the other hand, an approach which seeks to ensure that every funded activity is highly effective may be very slow, complex and inefficient. The optimum balance between effectiveness and efficiency needs to be found for each country and at each stage in the process which will almost certainly mean finding appropriate compromises.

1.1. Factors influencing ability to implement measures

In identifying factors likely to influence the ability of countries to implement the measures required for REDD+, information was drawn from the literature on absorptive capacity for development aid, together with experiences from existing programmes and projects which impact on forests. This analysis suggests that a number of factors are likely constraints for effective and efficient use of interim and longer-term financing for REDD+.

These include constraints at both the national level and at the level of implementation of specific activities on the ground. The latter is particularly important to consider in the case of REDD+ because of the range of different drivers which are involved in forest degradation and loss as discussed in Section 2.2.

Institutional constraints: At a national level, lack of effective institutions to develop coordinated strategies, poor transparency and efficiency of budget systems, patterns of public expenditure, the degree of decentralisation of resources and responsibilities, mechanisms to define policy priorities and accountability systems to hold governments responsible for performance have all been identified as influencing absorptive capacity. Lack of institutional capacity can range from a complete lack of important institutions to poor functioning of existing institutions due to inadequate resources or to inadequate institutional culture. Problems can be compounded if there are also competing external demands to commit the limited available resources to different policy areas (see Box).

Example: Competing objectives and lack of personnel – an example from FLEGT

There is a widespread consensus that improving forest governance is a key issue for effective REDD+ strategies in many countries. Yet there is growing anecdotal evidence from people involved in the FLEGT process, both within the EU (EC and various MS governments) and from partner countries, that the current focus on REDD+ is, in some cases, reducing both the political commitment and the availability of key personnel to work on forest governance issues.

At the level of implementation on the ground, experience from forestry, agriculture and rural livelihoods projects indicate that lack of capable local institutions and organisations to run or support programmes or initiatives are a key constraint.

Human capital: Lack of technical and managerial personnel is a major barrier to absorptive capacity. Everything from developing government policy to managing funds to implementing projects and programmes requires competent staff. At a national level the governments of poor countries often have problems recruiting, training and retaining qualified staff.

At a field level, it is often difficult to attract competent, well-trained people, who generally have a choice of jobs, to choose to live and work in forests, or on forest-agriculture frontiers which are almost always remote and lack basic infrastructure such as schools, hospitals and cultural activities.

At the other end of the spectrum, particular successes can often be attributed, at least in part, to good and effective leadership where the efforts and vision of a particular individual or organisation (or a combination) are crucial in making progress.

Political will: Lack of political will or political coherence is a serious constraint to effective and efficient implementation. It may exist for a number of reasons ranging from active opposition to a particular measure to lack of capacity to engage.

Example: Importance of political will

In Brazil political will at both state level (eg Amazonas) and at national level has resulted in a significant decrease in rates of forest loss. Conversely in Indonesia, lack of political at the sub-national level in some provinces and districts has resulted in continued forest loss even with support at a national level.

In many cases the situation is very complex with support at some levels or from some parts of government and opposition or lack of engagement from others. In practice, experience over the last three decades with a series of development aid-funded programmes and initiatives aimed at improving forest management and reducing forest loss indicates that progress is much less efficient and effective if political will is lacking, whereas rapid progress can be made where there is genuine political will.

Levels of finance received: in the case of development aid there is a growing body of research which indicates that if aid exceeds a certain level in relation to GDP, it ceases to be effective and can even be counter-productive (see Box 1.1 below). One aspect of this discussion, which has immediate relevance, is that the way in which aid is delivered (budgetary support, technical support, project support) and the institution via which it is delivered (government, private sector, NGO) has been shown to impact on its effectiveness.

The implications of absorptive capacity and ability to implement the measures required to achieve REDD+ are discussed in Section 2.

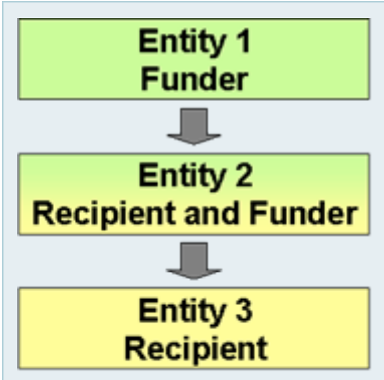
Box 1.1: Development aid, resource rents and absorptive capacity
There have been a number of studies which looked at the level at which increasing the flow of resources from development aid ceases to be effective in contributing to further growth. Different studies have estimated that this occurs when aid reaches anywhere between 15% and 45% of GDP [5,6] and suggest that beyond this level, aid may not only be less effective, but can in fact be harmful, undermining the national economy and resulting in declining levels of governance. Undermining economy: This may occur because significant levels of aid in the form of foreign currency could provoke a 'Dutch disease' effect; because aid flows are often unpredictable and volatile, and so can negatively influence macroeconomic stability, by triggering inflation and interest-rate and exchange-rate volatility; because aid increases can cause labour market pressures, by increasing demand for skilled labour and driving up wages. Impact on governance: This may occur because high (and increasing) levels of aid dependency can provide negative incentives for much needed reforms, and shift government accountability from domestic to international actors. By comparison, an analysis of the impacts of resource rents from oil on growth in poor countries suggests that they cease to be effective at an even lower level, i.e. 8% of GDP. The study suggests that this is because, in addition to the factors discussed above, rents are likely to be entirely captured by elite government and business interests and have negative effects on governance, while aid can be targeted in diverse ways, including towards technical assistance, projects, conditional funding packages and debt relief [2].

[5] From ODI (2005) Scaling up *versus* absorptive capacity: Challenges and opportunities for meeting the MDGs in Africa. http://www.odi.org.uk/resources/download/1369.pdf

[6] Cited in Collier (2005) Is Aid Oil? http://users.ox.ac.uk/~econpco/research/pdfs/Is-Aid-Oil.pdf

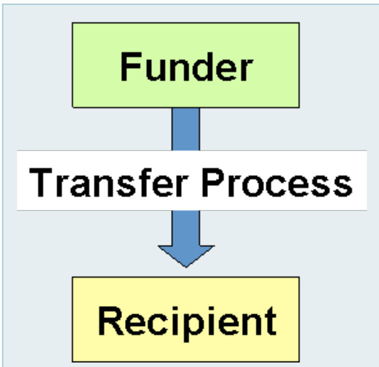
1.2. Factors influencing flow of finance to end-users

The second aspect of absorptive capacity is the efficiency and effectiveness of the funding architecture used, in particular;



Distributive capacity: Absorptive capacity is likely to be directly linked to distributive capacity. In general, the receipt and distribution of funding involves a chain so that the entity that receives funds will itself have to reallocate resources to the next stage down the chain thus becoming a distributer. Therefore, it is not only the ability of an entity to receive funding which is crucial, but also its ability to redistribute efficiently and effectively.

This in turn has important consequences for the model used to channel funding from the original donors through to the final recipients. In particular it is crucial to consider not just the ability of any entity in the chain to receive funding, but also its ability to redistribute effectively – the two together make up the overall absorptive capacity. This is the case whether the entity in question is a government department reallocating resources to various programmes and agencies, a regional or national development bank acting as a central point for funding, or an NGO providing payments to communities. Therefore, it is very important to understand the full suite of a country's existing funding mechanisms in order to identify the most appropriate agency(ies) to handle any particular type of task.



Transfer process: The ability of a recipient, whether a country or an institution, to 'absorb' funds is highly dependent on the interaction with the entity that distributes funds and, in particular, on the interface between the two. This transfer process, including the procedures for application, screening, approval or rejection and disbursement of funding, needs to be accessible, efficient and as straightforward as possible.

In ensuring that any early REDD+ financing mechanism is both efficient and effective it will be crucial to develop appropriate transfer processes at each stage in the financing chain. If it is too onerous or bureaucratic, it can become a major barrier to entry and create very high transaction costs. This not only creates inefficiency but may also exclude many relevant actors from involvement reducing effectiveness. Conversely, if it is too weak, there is a risk that money is disbursed ineffectively thus undermining the objectives of the funding. In developing appropriate transfer processes, it is important that there is consideration of the **level of materiality** of the requirements based on the level of funding being requested and provided (see Box 1.2).

In many cases, it has proved much more effective, particularly for smaller amounts of money, to focus on requiring accountability and transparency as the funds are spent, rather than onerous requirements at the application stage and this may be appropriate for interim finance.

Box 1.2: Level of materiality

It is very important to apply the right level of conditions to different levels of risk. Where sums are large and thus the risk associated with the funding not being used effectively is significant, it is appropriate to have correspondingly serious conditions of transfer for funds. On the other hand, where sums are small the risk associated with ineffective use of the funds is also small and it is appropriate to have correspondingly less onerous conditions.

For example, if a government department is applying for several million € to build its technical capacity for MRV it is perfectly appropriate to require substantive information justifying the need for funding and elaborating how it will be spent and to have detailed and legally binding conditions associated with its disbursement. An organisation which cannot respond to these requirements is unlikely to be able to use large sums of money effectively. On the other hand, if a small community organisation or NGO is seeking funding of a few thousand € to pay a salary for a year or organise some training, it could be a serious barrier to entry to require exhaustive information or demand complex contracts – particularly in initial phases when such organisations are likely to lack capacity. Therefore, it is important to design a process which is as simple as possible to encourage a wide range of organisations to become involved since the risk, even if the funding is not used effectively by several of the recipients, is small and accept that in a few cases funds with be used ineffectively – but that this is likely to be more effective than not using funds at all.

2. Capacity to implement REDD+ measures

There are significant differences between the relative abilities of different rainforest countries to engage with REDD+ which have implications for the design and implementation of the interim finance mechanism. This section addresses:

- The generic absorptive capacity of rainforest countries to obtain & use funding;
- The potential readiness of different countries to engage with REDD+ activities (and different phases of proposed REDD+ strategy – see Box 2.1);
- The potential for different countries to contribute their own resources to tackle REDD+.

Box 2.1: Proposed phases of REDD+

It is being proposed that progress on REDD+ in each rainforest country will involve three phases:

Phase 1: Initial REDD+ readiness, comprising REDD+ strategy preparation through an inclusive multi-stakeholder consultation process, and initial investments in MRV capabilities;

Phase 2: Implementation of enabling policies and measures according to the REDD+ strategy leading to emissions reductions verifiable through proxy-based indicators. This would include two different but complementary aspects of strategy implementation:

- **Phase 2a**: Payment on the basis of budgetary cost for enabling policies and measures (eg institution and capability building, development of legal frameworks and law enforcement capabilities, land tenure and forest governance reforms and MRV capacity);
- **Phase 2b**: Payments for performance against proxies (simplified methodologies) for implementation of policies and measures which deliver substantive emission reductions.

Phase 3: Participation in the UNFCCC compliance system (whether offsets, funds or other mechanism) enabled by IPCC-compliant MRV systems.

2.1. National level factors

It is clear that there are major differences in the absorptive capacity of different rainforest nations and also in their ability to attract different types of finance. In order to examine this further, a brief review was carried out based on two sets of factors that are likely to impact the ability to attract and utilise finance:

- Macroeconomic circumstances (eg FDI, ODA as % of GDP, DFID fiduciary risk assessment, sovereign/capital risk ratings);
- Governance indicators including both generic indices and forest-specific indicators (eg World Bank Governance Indicators, Transparency International Corruption Perception Index (CI CPI), forest governance capacity, historical and recent levels of forest loss).

There are other issues which may have an impact on the ability of countries to engage quickly and effectively with REDD+, such as the need to address land tenure (see Case Study 1). However, the analysis provided a basis for making some broad generalisations. It indicated that four groups of countries can be identified summarised in the table and discussed further below.

Group	Description
A	Countries which have access to international finance or substantial domestic investment, reasonable institutional capacity to absorb (manage and utilise) funds and have demonstrated the capacity and/or political will and coherence to make progress on achieving emission reductions or enhanced removals.
B	Countries which have access to international finance or substantial domestic investment, reasonable capacity to absorb funds at the national level, but face substantial institutional or cultural challenges to changing behaviour in the forest sector, and have not demonstrated the capacity and/or political coherence to make progress on emission reductions.
C	Countries which do not currently have access to international finance or domestic investment for the forest or agricultural sectors, but do have some capacity to absorb (manage and disburse) public funds, and have demonstrated some capacity and/or political will to address issues related to forest loss.
D	Countries which do not currently have access to international finance or domestic investment for the forest or agricultural sectors, do not appear to have the capacity to absorb (manage or disburse) funds, and have not demonstrated the capacity and/or political will to address issues related to forest loss.

While there are significant variations between countries even within one group, nevertheless it is possible to make some broad assumptions about each of the four groups:

Group A countries already have a considerable capacity to obtain and use funding through existing institutions and programmes, though these may need to be strengthened or scaled up to deliver emission reductions on the scale required. These countries have mostly already begun to achieve reductions in emissions or enhancement of removals (either directly in response to the current climate debate or due to other factors) and are likely to move quickly through Phases 1 and 2a of the proposed REDD+ strategy. Most will have the capacity to invest their own resources at an early stage provided that they see a reason for doing so.

Group B countries have capacity to obtain and utilise funding through existing institutions and programmes, but have not yet begun to achieve emission reductions or enhancement of removals, perhaps due to policy inconsistencies or lack of political will at some level. These countries are likely to remain in Phase 2a longer than necessary unless strategies are found to overcome the barriers to progress. They may have the capacity to invest their own resources at an early stage, but again political will is crucial.

Group C countries have less capacity to obtain and utilise funding through existing institutions and programmes but have demonstrated political commitment to make progress. These countries are likely to remain in Phases 1 and 2a for a considerable period unless implementation capacity can be improved rapidly. This may require a combination of providing support to existing institutions, creating new organisations and programmes and identifying innovative ways to rapidly increase capacity. These countries are less likely to have their own resources available to contribute in the early stages, though this may vary between sectors (discussed further in Section 2.2).

Group D countries have neither the capacity to attract and utilise funds nor the capacity to engage very actively with the REDD+ process in the short term. In these countries it will take time to develop capacity both within and outside government. For those which currently have high forest cover and low rates of forest loss, in order to avoid international leakage, it may be necessary to consider novel mechanisms for providing incentives not to accelerate rates of forest loss while greater capacity is developed.

In summary, the analysis indicates that there will be significant differences between different rainforest countries with relation to generic absorptive capacity, readiness to engage and make progress and ability to contribute their own resources.

- **Generic absorptive capacity to obtain and use finance**: Group A and B countries have reasonable absorptive capacity to both attract and use finance, whether from the public or private sector, which may need only minimal additional support. Group C countries are likely to have limited capacity which will require substantial additional support if these countries are to be able to obtain and use finance. In particular, these countries are much less likely to be able to access private sector finance if it becomes available unless they are provided with specific support for doing this. Group D countries have little or no capacity so it will largely have to be developed from scratch and innovative approaches may be needed;
- **The potential readiness of different countries to engage with REDD+ activities (and different phases of proposed REDD+ strategy):** Countries in groups A, B and C are all likely to be able to engage actively with Phase 1 of REDD+ and move into Phase 2a. Countries in groups A and B also have the capacity to transition from Phase 2a to Phase 2b relatively quickly, though for countries in group B lack of political coherence may slow this process at a national level. For group C countries, the lack of capacity to implement activities has the potential to be a significant barrier to the transition from Phase 2a to 2b (and therefore to be ready for Phase 3) and should be a major focus of interim finance. Group D countries are unlikely to have the internal capacity to engage very actively in the short term.
- **The potential for different countries to contribute their own resources to tackle REDD:** As with readiness, Group A countries are likely to be able to contribute their own resources to tackle REDD+ based on the availability of

reliable *ex-post* payments quickly (or are already doing so as in the case of countries like Brazil and Ecuador). Group B countries probably also have the potential but may not yet have the political will or coherence to do this. Group C countries are less likely to be able to accelerate activities based on their own resources in the short term, though this may vary by sector (this is discussed further in Section 2.2)

It is clear from the discussion above that the strategy developed for interim REDD+ financing will need to vary depending on the country. However, there is a further issue which is also important and needs to be considered relating to the range of drivers of forest loss. This is discussed in the next section.

2.2. Different drivers of forest loss

It is not only national differences between rainforest countries which will impact absorptive capacity, but also complexity within each country because of the diversity of activities or drivers which contribute to forest degradation and loss[7]. These drivers, several of which are likely to be relevant in any country, can be grouped into five main types:

- Commercial forest exploitation – harvesting of products from the forest, both legally and illegally, for sale, either domestically or internationally. This can range in scale from individuals harvesting firewood or single trees to large-scale industrial logging.
- Conversion to commercial agriculture – transformation of forest, both legally and illegally, for production of agricultural products to be sold domestically or internationally. This can range in scale from small-scale family farms to large plantations or agri-business.
- Subsistence use – harvesting or conversion of forest for subsistence use by poor rural communities. The impact of subsistence use on the forest can range from negligible where population pressure is low and/or uses have a low impact on the forest to very significant where population pressure is high and/or activities have a major impact on the forest.
- Infrastructure development – replacement of forest by infrastructure such as roads, settlements, mining or pipelines.

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[7] Meridian Institute (2009) Reducing Emissions for Deforestation and Forest Degradation (REDD): An Options Assessment Report. Prepared for the Government of Norway. Available from www.redd-oar.org;

Chomitz, Buys, De Luca, Thomas and Wertz-Kamounnikoff (2007) At Loggerheads? Agricultural Expansion, Poverty Reduction and Environment in Tropical Forests. World Bank.

Hoare, Legge, Nussbaum and Saunders (2008) Estimating the cost of building capacity in rainforest nations to allow them to participate in a global REDD+ mechanism. Chatham House and ProForest. Available from www.proforest.net.

- Natural disasters and accidents – particularly loss of forest due to fire (many other natural disasters cannot be controlled).

The type and combination of drivers varies both geographically within the country and over time. For instance, while expansion of subsistence agriculture may be a major driver in one region of a country, conversion of forests for commercial agriculture may be the most important driver in the neighbouring region. Furthermore, while commercial logging may be the most significant driver currently, next year it could have been replaced by subsistence farming or conversion to commercial agriculture.

Each type of driver has different impacts on the forest, involves different actors (government departments, companies, communities, NGOs, research organisation, markets etc.) and will need to be addressed by different mitigation strategies, each of which in turn has different potential to attract finance and different costs. Furthermore, while some are not particularly prone to international leakage (eg subsistence use), others can and do migrate rapidly between countries and continents (industrial logging, large-scale agriculture, mining etc)

As with the differences between countries, the differences between drivers has significant implications for strategies for achieving REDD+.

- **Driver-specific absorptive capacity to obtain and use finance**: there are two related issues which need to be considered:
  - There are likely to be significant differences in the capacity of different types of driver to obtain funding and to use funding. Thus, even in group A and B countries, some drivers may have weak capacity to attract or use funds (for example subsistence users) and may not make progress unless this is recognised and addressed. Conversely, in group C countries there may be some drivers which already have significant potential both to attract and use funds.
  - Closely related to the ability to obtain and use finance is the interest in doing so. Different drivers probably require different levels and types of incentive over different time periods in order to change behaviour. For example, there are unlikely to be significant cultural or economic barriers to persuading commercial timber concession-holders to change from destructive to sustainable logging practices on the basis of modest additional payments. However, there may be significant cultural resistance from rural subsistence farmers to changing their behaviour requiring time to achieve significant progress, while there may be significant economic barriers to engaging agribusiness on the basis of modest payments.
- **The potential readiness within a country to engage with REDD+ activities (and different phases of proposed REDD+ strategy):** The complexity of different drivers has a number of implications:
  - The large number of drivers means that a corresponding large number of national and local government departments and national and local policies

and programmes impact on or are impacted by REDD+. As a result, there is great potential for a lack of policy cohesion between different parts of government dealing with different sectors, either due to lack of capacity in government or due to differing levels of political will in different departments. As a result, there may be good progress in some sectors and little or none in others. This has very clear implications for making progress to the proposed Phase 2b where it is envisaged that payments will be made based on national emissions reductions. This is probably the main challenge in group B countries and may become an issue in other countries as well.

- The culture and ability to change practices varies both between types of driver and within each group of drivers. One example is agricultural intensification where large-scale agricultural producers in many rainforest nations have already begun adopting measures to increase productivity, whereas the smallholder agricultural sector changes more slowly. As a result, the point at which these different drivers begin to contribute to achievement of the overall REDD+ strategy for a country is likely to be very variable even if efforts to address them begin simultaneously.
- The proposed phased approach includes, as part of Phase 1 'the development of a national REDD+ strategy through a comprehensive, transparent, multi-stakeholder consultation process that includes indigenous and forest peoples ...'. In practice, however, the sheer number of organisations, institutions and individuals associated with the range of drivers means that there are a very large number of stakeholders who have an interest in or need to be involved in REDD+, many of whom have extremely limited capacity to engage meaningfully with any kind of consultation process at this stage. Therefore, there needs to be an ongoing process to a) build the capacity to engage and b) to have mechanisms for ongoing consultation as more stakeholders are able to engage (Box 2.2).

Box 2.2: Stakeholder consultation: lessons from FLEGT

Stakeholder consultation in developing legality assurance systems is an important ambition of the FLEGT process. However, in most countries it has taken time for many stakeholder groups to develop sufficient understanding of, and engagement with the process to become fully involved. However, meaningful involvement of civil society has been greatly accelerated by providing ongoing training and capacity building for NGOs (provided by organisations such as Fern and IUCN). Several commentators have suggested that creating a process which fosters genuine engagement of a wide range of different stakeholder groups, while still functioning imperfectly, has nevertheless been one of the early successes of FLEGT VPAs, and that this was achieved by keeping a constant focus on the issue, and providing ongoing capacity building.

- **The potential for different sectors to contribute their own resources to tackle REDD:** Even in countries which make rapid progress to Phase 2b nationally, there may be some sectors where there is limited interest or ability from either government or the actors involved in implementing activities. In this case, the payments being made would be for emission reductions achieved by tackling other drivers. The potential implications of this situation – where progress is made based on tackling some drivers but not others – needs to be further analysed to understand the long-term implications for REDD+. Conversely, even in countries which are not ready to move to Phase 2b nationally, there may be some drivers where government is already investing its own money (or development aid money) for other reasons such as poverty alleviation, improved governance or a more efficient agriculture sector or where there is significant potential for private sector investment (eg sustainable management of forests).

2.3. Discussion and recommendations

The discussion above raises some key points relevant to an interim financing strategy.

Raising funds versus using funds: so far initiatives focused on urgent short-term actions have focused mainly on how to raise finance quickly, together with some consideration of the financial architecture for disbursement (discussed in the next section). However, the analysis above indicates that even if finance is raised, it may fail to make an impact in many rainforest countries because there is inadequate absorptive capacity to access and use funds quickly and effectively. This needs to be urgently addressed through building on experience from existing programmes and initiatives and developing new and novel approaches.

Urgent consideration must be given (on at least the scale of the current consideration of how to raise finance) on the question of how to ensure that all rainforest nations are able to access and use the finance effectively.

Avoiding international leakage: There is a serious risk of both interim and longer-term finance resulting in international leakage if progress with REDD+ is made unevenly. There are two situations where this may occur. Firstly, if some countries make progress and others do not then mobile drivers are likely to move to the countries where there is less progress. This reinforces the importance of finding strategies that ensure that progress is made in all countries. Secondly, it may still occur even if all countries are engaged if several only address some drivers initially. This is particularly important because at least one of the drivers most likely to move between countries – conversion to large-scale commodity agriculture – is also a driver with high opportunity costs which may not respond to low level financial incentives and so may be ignored by a country while other, cheaper options are pursued.

In considering financing options it is crucial to ensure that there is enough flexibility to ensure that all countries are engaged and all drivers are understood and monitored even if not actively addressed. This requires a reasonable understanding of the complexity being dealt with.

Channelling payments to projects and programmes as well as countries: The core of the interim REDD+ strategy being proposed is to encourage countries to move as quickly as possible through phases 1 and 2a where payment is made based on budgetary support for undertaking specific activities to phase 2b where payments are made to countries *ex post* for emission reductions achieved (probably measured using a simplified methodology relative to the final full IPCC requirements).

However, it is clear from the analysis of countries and drivers that some countries are much more likely to successful at achieving overall emission reductions than others. For group A countries, guaranteed payment for carbon may be sufficient incentive to make progress nationally. However, in group B and group C countries there are likely to be significant barriers to national progress due to various absorptive capacity constraints, but there may be considerable sub-national variation with some drivers and some projects and programmes able to make progress. In this case, providing Phase 2b funding directly to individual projects or programmes (using appropriate methodologies to account for displacement and leakage) may be a very effective way to build capacity which can then gradually scale-up to a point where national progress is being made (this point also relates to the discussion of early market involvement and attracting risk or debt capital discussed further in Section 4).

Adopting an approach where performance-based payments (Phase 2b) are paid only on achievement of national emission reductions may be a serious barrier to progress for some countries. Allowing project or programme based payments initially may result in quicker overall progress nationally.

3. Financial architecture and disbursement capacity

In Section 1 the constraints to absorptive capacity related to the financial architecture itself were identified. The implications of this for any interim REDD+ financing mechanism are discussed in this section.

There are a number of possible ways to design a financial architecture for interim REDD+ payments. The analysis in Section 2 highlighted that there are significant differences both between countries and between different drivers within each country. This also has significance for the design of the architecture adopted by the interim finance mechanism. Whatever is adopted needs to recognise the variation both between and within countries and will need to be able to deliver financing efficiently and effectively to the entire spectrum of situations.

In order to be effective and efficient, as discussed in Section 1, there are two key considerations in relation to the organisations involved in the financing architecture:

- Distributive capacity of organisations: the ability of the fund-holder to distribute funds efficiently and effectively to users.
- Transfer process required: The appropriateness of the procedures for application, screening, approval or rejection and disbursement of funding.

Distributive capacity: For the interim finance mechanism it is particularly important that the institutions involved in disbursing funds are efficient as well as effective. Therefore, this should be a primary consideration in designing the architecture.

However, there are many examples of constraints in the distributive capacity of fund holders. This has applied to a variety of institutions ranging from the UN (the Global Environment Fund (GEF) was so inefficient at disbursing funds that it was broken into three funds) to governments themselves – both donors and recipients (see Box 3.1). There are many reasons for this, but important ones are the institutional culture and capacity of the organisation itself. This has the potential to be a significant barrier to the effective use of any interim finance if these issues are not considered.

In addition to the generic issue of poor distributive capacity there is an added complication for interim REDD+ finance. As discussed in Section 2, financing REDD+ will mean providing funds to a wide range of different countries and to a wide variety of different drivers in different sectors. Some financial institutions may be better at dealing with one type of country or one type of driver than others. This suggests that over-reliance on individual institutions, unless they have a proven track record of efficient and effective distributive capacity to a range of countries or, at country level, a range of drivers, is very risky.

It is also important that in designing the financial model there is an element of caution when drawing on examples of programmes which had a narrower focus and so had to deal with less variation in fund recipients.

Box 3.1. Case study: Inadequate distributive capacity

Small-scale mining in Ghana makes a significant contribution to national gold and diamond production and employs approximately 80,000 people. However, much of this activity is illegal and the environmental impact of mining causes serious land degradation and water pollution.

The Minerals Commission (MC) developed a strategy to regularise the sector and to reduce its negative environmental impacts. This included work to identify those areas suitable for small-scale mining, promotion of the creation of mining cooperatives, provision of technical and financial support to these cooperatives, and the promotion of alternative livelihood projects. However, the Ministry's performance reports for 2006 show that there was limited release of funds for this work (see table).

Table (from "Table 11: Implementation of Mineral's Commission programme of work, first quarter, 2006)

Programmed Activities	Budget Performance	
Identify & Investigate Areas for Small Scale Mining: Undertake geological investigation of areas identified for small scale mining	Planned Approved Released Expended	9,000,000,000 9,000,000,000 23,010,750 23,010,750
Alternative Livelihood Projects in Mining communities: Create alternative livelihood projects (Oil Palm pilot project)	Planned Approved Released Expended	14,961,573,000 14,961,573,000 0 0

Constraints on the release of these funds were reported as follows:

- Significant delays were experienced in trying to access funding from the Mineral Development Fund due to the complexities of tracking multiple funding sources combined with poor tracking capacity and lack of transparency within environmental agencies.
- The Ministry of Finance's practice of releasing funds on a monthly basis did not allow for effective planning, and was administratively cumbersome.
- Decisions over the release of funds by the Ministry of Finance appeared to be discretionary and further oversight on the release of approved budgets was identified as being needed.

The report's primary conclusion was that the top priority of development partners should be the promotion of improved governance structures, including removal of conflicting agency mandates and the funding of regulatory activities through an existing government-wide Consolidated Fund rather than internally generated funds (e.g. from external donors, etc.)

Source: Bird and Avoka (2007) Budget support, aid instruments and the environment: The country context. Ghana Case Study. ODI and CDD-Ghana. (http://www.odi.org.uk/ccef/resources/reports/s0166_ghana2.pdf)

Transfer process: To be efficient and effective it will be necessary to design a transfer process which delivers an acceptable level of effective utilisation of funds being spent while still being efficient.

In very simple terms, effectiveness requires that all those that should be receiving funds (because they will use them to enhance progress to REDD) are able to access them and all those that should not be receiving funds (because they won't use them to enhance progress to REDD) are not able to access them. In practice, the main focus of funders is often too much focused on the second of these with the result that funds are either not disbursed at all, or are disbursed only to the type of organisations able to go through complex application procedures and meet complex conditions.

For REDD+ interim financing it is important to make the transfer process sufficiently robust that there is not widespread misuse of funds received, but also to design mechanisms which are appropriate to the use envisaged and which treat the degree of materiality appropriately. One way of doing this that is being increasingly widely adopted, particularly for smaller-scale funding is to have a relatively simple process and set of conditions, and to focus instead on accountability and transparency in the use of funding (see Box 3.2).

Box 3.2. Case Study: Using accountability and transparency instead of conditions

In 2006 two organisations – the Dutch Doen Foundation's Oils programme and the GEF-IFC Biodiversity in Agricultural Commodities (BACP) programme - both announced funding for projects (in the $50 – 200K range). to support greater sustainability in the soy and oil palm sectors

Doen developed an extremely simple set of objectives (1 side) and invited short applications in the applicant's own format – but not to exceed 3-4 pages (plus a budget). However, they included quite strict requirements for provision of information on implementation and an independent financial audit of spending. The funding has now been used successfully for a whole range of projects and is widely recognised in the sector as having been very effective in supporting early activities and making a valuable contribution to progress over the last three years.

The BACP programme spent over a year developing a strategy document of about 50 pages and finally opened a first call for proposals 18 months late. The application forms are complex and require detailed information on links to the strategy document, breakdown of spending, indicators of success and other factors. To date the number of proposals received is less than anticipated, few projects have been approved, even fewer received funding and there has not yet been much impact on the ground.