Knowledge for Development and Diplomacy

K4DD Synthesis Note

A Broader and More Long-Term Approach to Public Financial Management: Managing Fiscal Risks Associated with Climate Change

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December 2024

This synthesis note draws on the material contained in five rapid evidence reviews[1], which provide more detailed evidence, data and references to support the points summarised here. The synthesis note is also informed by discussions at the first evidence and policy clinics[2]. It sets out the ideas from the first clinic on the benefits of moving toward a broader and more long-term approach to public financial management, and then considers what this means for the management of fiscal risks associated with climate change.

1. Moving beyond the annual budget cycle[3]

Donors and developing country governments have put a great deal of emphasis on strengthening budgetary systems in developing countries. However, the results have been mixed. A host of factors such as the complexity of the budget, the process of annual repetition and the difficulty of removing resources once they have been allocated all make the budget an inherently contested process.

Concerns have been raised that even a well-functioning budgetary process might create perverse incentives by focusing on the annual cycle. This has led to significant attention being given to more long-term approaches to budgeting and planning and, more recently, to a broader focus on government balance sheets.

There have been challenges in operationalising these more long-term approaches. Where the annual budget cycle is strong, other approaches tend to be subordinated to the focus on the budget. Where the annual budget cycle is weak, data systems tend to be weaker and less able to inform realistic forecasting. However, imperfect data does not prevent more long-term approaches playing an important role in informing and guiding government policies and budgets. Managing risk and uncertainty necessarily involves working with imperfect data and the priority is often to acknowledge and work with these limitations.

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[1]The five rapid evidence reviews are:

- Long-term approaches to planning and budgeting: challenges and opportunities in moving beyond the annual budget cycle by Tom Harrison
- Managing risks through government balance sheets by Dr Laurence Ferry
- Managing fiscal risks, assets and liabilities related to climate change by Kathryn Cheeseman
- Managing fiscal risks related to climate change: case studies by Brian Lucas
- Influences on climate change-related fiscal risk management by Mahdi Zaidan

[2] Evidence and Policy Clinics provide FCDO teams with direct support on their development of evidence-informed analysis of challenges and possible interventions. Built around learning events and evidence reviews, the clinics support broader policy development or programme focused business planning.

[3] This section summarises the rapid evidence review by Tom Harrison on Long-term approach to planning and budgeting: challenges and opportunities in moving beyond the annual budget cycle.

2. Understanding and managing fiscal risk[4]

Fiscal risk refers to things that could go wrong and impact adversely on the government's fiscal projections. Fiscal risks arise from a wide range of events including conflict, pandemics, climate change and the cost of public debt. Fiscal risks can originate in all areas of the economy, either impacting directly on the public sector or impacting indirectly where the government needs to provide support for businesses or livelihoods.

Much of the literature emphasises the need for good quality data to manage fiscal risks, but there is also recognition that data capabilities may have to be developed over time and that managing risk is inherently about managing uncertainty. A move towards a broader and more long-term approach to public financial management (PFM) could help to build the quality of data and to develop the ability to anticipate and respond to fiscal risks.

Box 1

Conclusions from the first clinic

The first policy clinic was used to validate and build on some of the initial thinking. It highlighted the need to:

- Develop broader and more long-term approaches to planning and managing public finances.
- Recognise that overreliance on the annual budget cycle can create perverse incentives.
- Remember that broader and longer-term approaches need to be pursued incrementally, grounded in context and understanding of political economy.

The second clinic seeks to build on these conclusions by exploring these issues in greater depth by focusing on the fiscal risks associated with climate change.

3. Fiscal risks associated with climate change

Managing the fiscal risks associated with climate change involves anticipating and responding to uncertainty. This is partly due to the availability and reliability of data, but more fundamentally due to inherent uncertainty over which risks will materialise, when they will occur and what impact they will have. Risks include damage to infrastructure and disruption of livelihoods, and the associated impacts on government revenue and expenditure. They also include the risks associated with delaying mitigation including the creation of carbon intensive infrastructure that may later become redundant and delaying adaptation by building infrastructure that is not equipped to deal with future changes in climate. A focus on risks needs to be broad enough to take account of non-monetised risks associated with environmental degradation, nature loss, and broader social and welfare implications.

There are multiple tools available to analyse fiscal risks associated with climate change. Natural hazard resilience and responses have been integrated into the Public Expenditure and Financial Accountability (PEFA) framework. The United Nations Environment Programme (UNEP) lists 72 risk evaluation tools in its online database. Recommendations for managing fiscal risk often overlap with priorities for public financial management (PFM) more broadly including clarifying roles and

[4] This section summarises the rapid evidence review by Laurence Ferry on Managing fiscal risks through government balance sheets and by Kathryn Cheeseman on Managing fiscal risks, assets and liabilities related to climate change.

responsibilities, effective budget management and control, and the quality of data. Other recommendations with more specific implications for managing climate related risks include aligning PFM with climate change targets, the ability to respond rapidly, planning ahead and social inclusion.

Box 2 – integrating climate change into PFM processes

Odisha, a coastal state in eastern India, was the first subnational government to apply climate budget tracking (identifying, measuring, and monitoring climate-relevant public expenditure) to inform its 2020-2021 Climate Budget (Edelman, 2024, p. 9).

Bangladesh has begun climate tagging its budgets – tracking expenditure related to climate change programming and enhancing the tracking of expenditure through more efficient accounting systems and coding of budgets (Ponniah & Tominaga, 2023).

4. The importance of context[5]

The fiscal risks associated with climate change differ across regions and over time. The risks are particularly pronounced in countries that are most exposed to natural hazards, where economic activity is concentrated in a few areas, and where public finances are particularly constrained or inflexible (Mitchell et al., 2014, p. 419).

Differences in geography, economic development, and governance impact how governments manage climate-related fiscal risk. Areas with specific geographic vulnerabilities (small islands, coastal states and arid regions) require additional infrastructure investment to adapt to rising sea levels or intensifying aridity. Regional similarities also create incentives for collaboration on common threats. small island developing states (SIDS) are particularly at risk due to rising sea levels and have collaborated to advocate for climate financing. Coastal regions more broadly are exposed to rising sea-levels. The increased cost of borrowing associated with these risks has spurred some innovation in creating new financial instruments.

State capacity and political considerations can affect success in adopting and managing strategies to manage climate-related fiscal risk including the ability to manage complex crises, to plan and implement appropriate policies, and to set and measure appropriate indicators.

5. Learning from examples[6]

The final review looked at five case studies and used them to extract some broader lessons about what works. We hope participants will share other examples during the policy clinic.

Case study
1. The Coalition of Finance Ministers for Climate Action (CFMCA) is a network of 95 national finance ministries that exchanges expertise and experiences on policies, promotes common standards and best practices, and supports coordinated responses on climate change issues (CFMCA, 2024e, p. 2).

[5] This section summarises the rapid evidence reviews by Mahdi Zaidan on Influences on climate related risk management and Kathryn Cheeseman on Managing fiscal risks, assets and liabilities related to climate change

[6] This section summarises the rapid evidence review by Brian Lucas on Managing fiscal risks related to climate change: case studies

2. The 'Room for the River' programme in the Netherlands sought to manage flood risks which are increasing due to climate change and to provide environmental and recreational benefits (Goossen, 2018; OPSI, 2019; Schasfoort et al., 2013; Verweij et al., 2021, pp. 204–205).

3. Bangladesh's Climate Fiscal Framework (CFF) is a tool for tracking, assessing, planning, budgeting, auditing, and mainstreaming climate finance in government decision-making (Ministry of Finance, 2022, p. 9). It is intended to guide the integration of climate change considerations into public financial management systems (Cooke, 2018; Ponniah & Tominaga, 2023; UNESCAP, 2024, p. 12).

4. The Caribbean Catastrophic Risk Insurance Facility (CCRIF) insures governments and electric utilities in the Caribbean and Central America against natural disaster risks, providing rapid short- term financial liquidity to bridge the gap between immediate emergency response and longer-term reconstruction activities (CCRIF SPC, 2024; Hochrainer-Stigler et al., 2023, p. 212).

5. Costa Rica's National Decarbonization Plan sets an ambitious goal of achieving green economic growth and net zero carbon emissions by 2050 through more than 70 targets and actions spanning the entire economy (Elliott et al., 2024; Groves et al., 2023, p. 41). It seeks to align government spending with growth and decarbonisation objectives, mobilise private and international finance towards these goals, and adjust fiscal policy to manage potentially disruptive impacts of the decarbonisation programme.

The review identified common factors that contributed to these five initiatives:

1. Building on existing expertise, capacities, systems, and assets, such as Dutch expertise in flood protection, or Costa Rican investments in hydroelectric power.
2. High-level political support and leadership, such as Presidential leadership of the Costa Rican National Decarbonization Plan or making flood protection a core national priority in The Netherlands.
3. Active engagement with local stakeholders to ensure support, such as the participatory development process of the Costa Rican National Decarbonization Plan, or the responsiveness to members shown by the Caribbean Catastrophic Risk Insurance Facility.
4. International technical and/or financial support, particularly in low- and middle-income contexts, such as technical assistance for the development of Bangladesh's Climate Fiscal Framework, or providing capital for the Caribbean Catastrophic Risk Insurance Facility.

Box 3

Questions to consider for the policy clinic

- What examples are there from the contexts you work in and the issues you work on?
- How much attention is given to fiscal risk?
- What are the obstacles to accommodating fiscal risk?
- What role can/should the FCDO play?
- What role can/should PFTD play in supporting FCDO work in this area?

Suggested citation Harrison, T., Ferry, L., Cheeseman, K., Lucas, B., and Zaidan, M. (2024). *Synthesis Note: Broader and Long-Term Approaches to Public Management*. K4DD Rapid Evidence Review. Brighton. UK: Institute of Development Studies. DOI 10.19088/K4DD.2024.083

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