Moving to clean energy

Public finance, not just private capital, must help fund the transition

SURANJALI TANDON

AS PER the IPCC report, the world is heading towards warmer climate and higher sea levels. The impact of climate change has become more palpable for many countries in recent years, leaving no room for cynicism. In response, governments have sprung to action to halt the unbridled consumption of fossil fuels. Countries have set ambitious targets for emission reduction. The removal of fossil fuel from production processes is not an easy task, especially for developing countries such as India that rely heavily on coal for power generation, and production of cement, iron and steel. To expect a transition away from fossil fuels would not only require massive investments in alternatives and technology, but also dedicated expenditure to restore the livelihoods of those dependent on these sectors. Acknowledging the steep challenge, the Indian government has committed to a "phase down" — instead of a "phase out" — of coal and fossil fuel subsidies, thus leaving room for the country to chart its own low carbon transition pathway.

Some see this as a watering down of the Glasgow agreement, but it is important to appreciate the history, economics and finance of the semantics. Years of industrial revolution coincided with the rapid expansion of imperial power. Countries such as India acquiesced to the advent of coal powered railways, which became an ally of thriving imperial commerce. Estimates of India's remaining carbon budget must factor in early emissions spent to the detriment of its economic progress. In the years after independence, coal was a prominent input and communities came to depend on it. Today 38.5 per cent of districts in India have some form of coal dependency. Households also depend on gas and petroleum for cooking and transportation. Therefore, a low carbon pathway must take into consideration the costs to workers and consumers. Ignoring such interests can be perilous, as was seen in the UK, where the shutting down of inefficient coal mines in 1984 led to massive strikes, adversely impacting livelihoods in coal dependent regions.

While India remains in charge of its destiny, the process of transformation has been set in motion. This is seen for companies in high carbon value chains — automobiles, cement and steel — that have committed to sustainable practices. This shift in thinking is in part the result of pressure from investors to acknowledge the long ignored social costs of profits. Companies under varied regulatory regimes are now required to disclose their non-financial performance on environment, social and governance indicators. Although, their objective and consistent application may be questioned.

Investors seeking to align social and financial returns have invested in these companies directly through the purchase of green bonds and sustainable bonds or through funds that rely on ESG disclosures for portfolio decisions. Covid-19 has provided a further nudge to such thinking. In 2020, assets under management of ESG funds grew by a record $51.1 billion. It was a record year for green bond issuances. As the wheels of change turn, it is natural for a skeptic to inquire if this is truly a change of heart for capitalism. Evidence suggests that not all companies live up to their lofty promises. Major corporations around the world have been called out for deceiving investors and consumers. As a result, there are now demands to curb such greenwashing, be it through regulation or class action suits.

As regulation catches up with intent, a more pressing question is if private finance is enough to fill the financing gap? The transition is an economy-wide change that is also likely to impact segments of the society that remain uncovered by corporate spending on social responsibilities. Therefore, private finance will have to be complemented by public finance. It is expected that public finance will become even more pivotal. However, there is a simultaneous risk to future revenues from the tapering of fossil fuel consumption. These account for roughly one-fifth of India's tax revenues. Moreover, the decline in tax revenues is also likely to impact sovereign credit ratings. According to a study, 63 countries including China, Chile, Malaysia and Mexico could witness a ratings downgrade as a result of climate change. This presents a conundrum for governments that are willing to make the shift, but will not have the requisite fiscal capacity.

Furthermore, such risk can spill over into bank balance sheets that hold sovereign debt while private debt extended to fossil fuel dependent sectors could also turn unviable. This risk is particularly high for countries such as India where around 10 per cent of commercial bank loans are to carbon intensive sectors, half of which are attributable to the power sector. The OECD countries suggest that ascribing a price to emissions through a higher tax is a plausible solution. But, as consumption of fossil fuel tapers, these revenues will decline and any increases in the rates to compensate for this decline can potentially spur inflation, leaving consumers to pay for the cost of transition.

One way or another, there are costs to this transition and the risks are pronounced for the sovereign. The issue therefore is how these costs are distributed. As per an estimate by the Council on Energy, Environment and Water, the investment requirement for meeting the net zero target will be $10.1 trillion. The promise of $100 billion from developed countries for climate mitigation pales in comparison to the needs of developing countries such as India. Therefore, multilateral and private capital must enhance their commitments to invest in low cost technology. Sovereign borrowing dedicated to this transition must not be discounted by ratings. Creating a development finance institution dedicated to low carbon transition can help accurately assess the finance required, and streamline the transition spending.

The writer is assistant professor, NIPFP