Climate finance needs overhaul, funds influx

Climate finance is the focus of the spring meetings of central bankers, experts and ministers of finance as they seek to set the tone for this year's Conference of Parties (COP). Low-income countries have long complained of the failed climate-finance promises, with the developed world not meeting the $100-billion annual target until recently. This year presents an opportunity to be more ambitious while setting the new collective quantified goal (NCQG). As negotiators set their eyes on the revised commitment, it is also time to reflect and learn from past experience.

The foremost concern for negotiators and experts is that the term climate finance remains ill-defined. This is particularly important since climate finance flows are largely composed of debt, and barely 15% of it is concessional. Nearly half of these flows are from the private sector. There is also significant overlap between development and climate finance flows. The line between the two remains blurry, and it is essential to identify new and additional resources. Also, the contributions to climate adaptation that require public finance have been less than satisfactory.

Suranjali Tandon

Given these shortcomings, it is important to turn attention to the sources of the $3-6 trillion required to reach the net zero goal. While there is sufficient attention on international public finance flows, there is a need for clear prioritisation — what kind of capital will be available for adaptation and what will be available for mitigation. Evidence bears that private capital can be channelled to commercial mitigation projects, but public finance will remain critical for adaptation. This means the ease of access to funds from the multilateral bodies will be important. The independent expert group of the Indian G20 presidency explored ways through which multilateral development banks (MDBs) can optimise their balance sheet by accounting for callable capital, removing lending limits, and preferred creditor treatment. These changes are possible with the shift in shareholder expectations. More importantly, the approach to credit ratings, which treat comparable low-income country projects as low quality, needs to be reassessed.

Another critical aspect is the determination of the manner of contribution and distribution of international capital. There are formulaic possibilities of basing contribution on per capita income and level of development, along with historical contributions to emissions. In terms of distribution, capital may be provided as per the share in mitigation and adaptation costs read along with income levels. The setting of NCQG on an economic basis that can be revised over time is a seminal issue. For example, India, in its submission to the NCQG ad hoc group, recommended a 2% of Gross Domestic Product contribution for developed countries.

Conscious of the demands of developing countries, international capital will indeed play a role. There are, however, barriers to the scaling up of such capital. First, exchange rate shocks from a massive inflow can be significant. Second, if the flow continues to be in the form of debt, heavily indebted countries stare at a dire fiscal future. Therefore, developed countries must be urged to be more considerate towards the macroeconomic constraints of the developing countries, which would include providing an option of moratorium, if not a write-off on the debt.

Domestic resource mobilisation will also contribute to climate finance. Domestic taxes can be an instrument, but the task force on international tax expects that this would be met through a carbon levy on maritime transport, financial transaction tax (FTT), global minimum tax, and carbon taxes. But are these revenue streams sustainable in the long term? For example, studies estimate that the global minimum tax will generate $150 billion annually, across the globe. Carbon taxes need to be capped to be less distortionary. Similarly, FTT rates cannot be implemented without global coordination among large financial markets. The distribution of global levies also needs to be thought through. On top of this, the use of taxes for support needs deeper domestic reforms. Such reforms would, in turn, depend on economic structures.

As NCQG takes shape, developing countries need to assess the extent to which international capital will be sustainable and necessary. The propositions concerning national contributions need to be based on economic rationale and revised periodically. Lastly, while levies are an attractive proposition, they should not be implemented without considering the growth and investment concerns of developing economies. A more fundamental shift is to think of a package of reforms consisting of domestic resource mobilisation and a shift in the way international financial institutions assess developing country risks.

Suranjali Tandon is associate professor at the National Institute of Public Finance and Policy. The views expressed are personal