



Policy Brief

INTERNATIONAL FINANCING FRAMEWORK TO BRIDGE THE CLIMATE FINANCING GAP BETWEEN DEVELOPED AND DEVELOPING COUNTRIES

Task Force 7

International Finance and
Economic Recovery

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Abstract

To tackle climate change, countries need to channel more capital to green projects. Additionally, typical green projects tend to have a lower return and/or higher fixed costs relative to brown investment projects. This, along with the higher cost of capital and limited fiscal spaces, means that the state budget of developing countries will not be enough to fulfil the financing needs of climate-related projects. Furthermore, shallow domestic financial markets also limit the available domestic funds for green projects in developing countries. This policy brief proposes an actionable framework to promote the flow of private capital from developed countries into green projects in developing countries.

Challenge

With the emergence of a global consensus to limit the global temperature rise to within 1.5 degrees Celsius to 2 degrees under the Paris Agreement, the next significant challenge that all the countries collectively face is to formulate and take concrete steps toward achieving this goal. In order to limit the global temperature to the agreed level under the Paris Agreement, the Intergovernmental Panel on Climate Change (IPCC) found in 2018 that “rapid, far-reaching and unprecedented changes in all aspects of society” must occur. Supporting this unprecedented initiative requires financing on a massive and unprecedented scale. Based on a CPI (2021) estimate, the level of financing needs will amount to between US\$4.5 trillion and \$5 trillion annually from 2021 until 2050, equivalent to roughly 6 percent of global gross domestic product (GDP) in 2020.

Raising funds on such a scale requires global coordination, particularly with respect to the commitment to “making the finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development” under the Paris Agreement. Unfortunately, despite the stated commitment, there is still a huge gap in financing for climate action. Even though total climate finance has steadily increased over the last decade, reaching \$632 billion in 2019/2020, this is nowhere near the required amount and has to be scaled up by at least 590 percent annually by 2030 to meet the Paris climate objectives.

The gap between the stated intent of Paris Agreement signatories and implementation is even more pronounced when it comes to the push towards decarbonization in lower- and middle-income countries. Many lower- and middle-income countries, despite their commitment to decarbonization, often find themselves constrained by their limited fiscal space and binding external financing constraints. Even before COVID-19, large-scale decarbonization efforts in lower- and middle-income countries oftentimes meant sacrificing other budgetary items that are essential to the long-term economic development agenda, such as basic infrastructure, schools and hospitals. COVID-19 further exacerbated the fiscal constraints faced by lower- and middle-income countries, as they now have to prioritize short-term economic recovery over financing longer-term development projects or decarbonization. In addition, their domestic financial markets are not deep enough to raise the necessary full-scale decarbonization efforts in the face of an ongoing revenue shortfall. Financing climate-related projects in these countries thus requires capital from international investors.

Leaving low- and middle-income countries to shoulder the full cost of climate change mitigation and adaptation is not only unfeasible, given their fiscal constraints, but it is also unfair. This stems from the fact that addressing climate change will bring common benefits to every country collectively, but the economic costs are asymmetrical and skewed towards

developing countries on relative terms. Low- and middle-income countries in general face a higher cost of capital (both financial and economic), and diverting the resources that can instead be used for other long-term economic development needs means that the opportunity costs for climate mitigation projects in developing countries are also higher than in developed countries. Mobilizing funds from developed countries to developing countries for climate-related projects at a low cost is, therefore, critical to achieving the common goal of keeping global temperature increases to 1.5 degrees above pre-industrial levels, as mandated by the IPCC.

At the same time, the unprecedented fiscal deficit due to ongoing recovery efforts from the COVID-19 pandemic has put additional strains on many developed countries' fiscal position and precluded large-scale intergovernmental transfers in the short- to medium-run. The relatively limited fiscal space due to the increasing debt-to-GDP ratio and existing domestic political constraints means that the feasible amount that can be allocated through conventional financing instruments, such as government-to-government soft loans and/or direct aid, will be short of the amount needed to meaningfully assist developing countries in their transition to a net-zero economy. As such, alternative sources of low-cost funds for climate projects in developing countries are urgently needed to fill the gap.

Proposal

THE NEED TO PROMOTE INTERNATIONAL CAPITAL FLOWS TO GREEN INVESTMENTS IN DEVELOPING COUNTRIES

The main problem concerning the financing of a green transition is supply, in which the financing needs for green projects do not match the volume of investment flows to these sectors. Given the high cost of development for green projects, the government budget – especially in developing countries where there is usually limited fiscal space and capacity – cannot solely fulfil these needs. Banks with short-term liabilities are also not well-suited to hold long-term assets. In addition, a rather shallow domestic financial market in developing countries means that the domestic financing capacity for green projects is substantially low. In that view, the available financing options for green projects in developing countries are rather limited and the economy must look for alternative financing, particularly from the international capital market. However, the lack of a standard international framework on green financing plays a role in spurring global capital flows towards achieving net-zero emissions, as the historical trend of channelling capital to green projects is rather unpromising.

In addition to a lack of a standard international framework on green financing, the complexity of the taxation regime that international bondholders are likely to face on bond ownership creates more hurdles for financing climate mitigation and adaptation projects in developing countries. As the national authorities maintain sole jurisdiction on taxation, the tax implications of cross-border ownership of sovereign bonds creates a high degree of variability, both in terms of the tax rate that bondholders are liable to pay and the authorities to which bondholders are held liable on their interests and capital gains. Even under a favourable scenario where foreign bondholders own bonds issued in jurisdictions that have entered double tax treaties with their country of residence, their portion of interests may still be taxable according to the applicable treaty rate. This problem is further exacerbated if the issuing country has not entered a double tax treaty, which may result in double taxation on the bonds' interests.

Reducing the effective interest rate payable by developing countries for climate-related projects is very crucial to achieving climate goals for two key reasons. First, given the highly capital-intensive nature and long-term horizon of a lot of climate-related projects, the interest rate is crucial to determine whether green/non-polluting technology is an optimal investment decision (Stock, 1984; Iyer, et. al., 2015; Steffen, 2020). Since a lot of capital investment decisions (even the publicly funded ones) are evaluated by their weighted average cost of

capital, reducing the level of interest rate payable by the borrower for green projects should broaden the feasible sets of green projects that developing countries can undertake. Considering that most developing countries are faced with high-risk premia to begin with, broad-based international efforts to lower the interest cost will be important in increasing the uptake of green projects in developing countries at the margin.

Second, and more importantly, most developing countries are in a shakier fiscal condition relative to pre-COVID-19 baselines and as such, may not be in the best position to prioritize climate-related projects without any external interventions. Two years into the pandemic, virtually all developing countries have amassed higher debt-to-GDP ratio and have yet to fully recover their fiscal capacity from the pandemic lows. Higher energy prices due to the war in Ukraine have exacerbated the problem faced by many developing countries. Already, we have seen net oil-importing developing countries being forced to reintroduce or increase fuel and energy subsidies. Given the situation, forcing developing countries to shoulder the burden of climate change mitigation and adaptation without significant and systematic assistance from net creditor countries is neither fair nor feasible.

INTERNATIONAL FRAMEWORK TO ELIMINATE INCOME TAX ON INVESTMENT IN QUALIFIED SECURITIES RELATED TO GREEN PROJECT INVESTMENTS IN DEVELOPING COUNTRIES

The introduction of an international framework to eliminate income tax on green-project-backed securities have the potential to incentivizes private institutions from developed countries to lend money to developing countries below the current market rate. This is to be achieved by making global loans/bonds for qualified climate mitigation and adaptation projects in developing countries eligible for interest and capital gain tax exemptions in all participating jurisdictions. Further incentives can be given by means of direct interest subsidies for loans/bonds issued by highly indebted poor countries to provide more equitable access to much-needed climate financing. Specifically, we propose the elimination of the tax on interest income for the beneficial owners of qualifying green bonds issued by eligible developing countries. Under this proposal, the bondholder of this eligible green bond who is a legal resident of a participating signatory will not be taxed by any of the following: (1) the country of which the bond issuer is a legal resident, (2) the country where the bond is issued and (3) the country of which the bondholder is a legal resident. In practical terms, so long as the bond is issued by, marketed in and owned by a legal resident of any of the participating countries, the bond will be fully tax-exempt.

This financing framework is designed to solve two key issues in financing climate change mitigation and adaptation in developing countries. First, by providing a preferential tax treatment for debts issued by developing countries for climate finance projects, developed

countries can help provide significantly more financing for mitigation and adaptation projects than is possible through direct government-to-government (G2G) lending. Second, this framework provides a pragmatic solution to the domestic political challenges faced by developed countries' governments in appropriating a sufficient budget for climate aid and financing for developing countries. Given that tax breaks for climate finance can be made less politically salient relative to direct aid, passing the tax break legislation should, in theory, be easier through the normal budgetary process.

INSTRUMENT DESIGN

A practical consequence of a simple and transparent multilateral tax exemption is that investors from any of the participating jurisdictions will be much likelier to accept lower yields relative to the equivalent non-tax-exempt bonds by roughly the prevailing tax rate on interest. The expected equilibrium would be a higher capital flow from relatively yield-starved developed markets' institutional owners to green projects issued under this mechanism at a lower interest rate. We expect that successful implementation of this mechanism should result in a higher number of successful green projects being undertaken in the medium to long run.

As the bond issuance process under this mechanism should not differ significantly from that of normal bonds, and as tax-exempt bonds have already existed (albeit in different forms and for different purposes, such as tax-exempt municipal bonds in the United States), we expect the main issues surrounding the implementation of this mechanism to be: (1) which type of issuers may support this mechanism and (2) how restrictive the covenants of this bond should be with respect to the use of its proceeds.

With regard to eligible issuers, we propose to initially reserve this facility for the national/central/federal government, local governments and other institutions that are majority-owned and majority-controlled by the national/central/federal government of eligible countries, including state-owned enterprises. This seems to be a sensible and pragmatic first step, given that the investment opportunities in climate-related projects that are available to private institutions in many developing countries are oftentimes too small in scale to take full advantage of this facility. Besides the inherent risks of the project(s), the benefit of reserving the initial implementation for government-related institutions is that it could prevent institutional risks. Due to the relatively low institutional capacity of developing countries, financing projects that are carried out under the umbrella of government-related institutions could lower the risks that might arise from issues related to property rights and bureaucratic issues, including administrative inefficiencies, delays in the processing of permits and licenses, and changes in rules and regulations. Additionally, providing funding to government-

related institutions for climate-related projects may help incentivize the issuing government to fast-track the projects' execution and implementation. This facility, however, does not preclude the possibility of expanding the funding eligibility to private, for-profit enterprises if it is deemed desirable and practical.

The heterogeneity of the fiscal and institutional capacity of countries under the umbrella of "developing economies" means there may need to be more specific criteria for eligibility under this mechanism and additional financing mechanism for highly indebted developing countries. While this ultimately is a political decision, some useful starting point would be to use the classification mechanisms that have already been constructed by other multilateral institutions (e.g. upper, middle-income countries and below). Developing countries with a high level of indebtedness that would benefit from climate financing would probably require more assistance, such as in the form of interest subsidy being made available from the collective subsidy pool by Group of 20 (G20) member states.

On the issue of how restrictive the bond should be, we propose to restrict the use of the bond's proceeds to financing pre-specified climate project(s). This is to address the issue of project accountability and avoid even the impression of greenwashing. The purpose of this mechanism is, first and foremost, to leverage the private capital channelled from developed, cash-rich nations to developing countries at a lower cost and to allow the proceeds of this bond to be set aside for climate projects. To minimize the risk of this mechanism being misused for general deficit financing, the periodical monitoring of the projects' progress is key, even if the bonds may not be issued as project bonds. We do not preclude the loss of tax exemptions as a disciplinary mechanism that helps keep the financed climate projects on track.

ROLE OF G20

The introduction of any new international financing framework proposal that may require a significant adjustment of legal codes at the national level, including our proposed framework, requires the endorsement and buy-in of a significant bloc of global economies to gain traction and move forward. To achieve this, the G20 could serve as an effective forum for discussing the key implementation details of such financing framework. To further enhance the development of a concrete proposal of an international framework to eliminate income tax on green projects-backed securities, we recommend several initiatives that could be taken by G20 member countries:

- Take charge in encouraging the necessary framework setup and design feature of the proposal.

- Coordinate with major global institutions, including the Organisation for Economic Cooperation and Development (OECD), the International Monetary Fund (IMF) and World Bank, and global private financial institutions and rating agencies to develop the road map of an international financing framework that incorporate the differences in countries' characteristics to ensure the applicability and marketability of the proposal.
- Mobilize resources to enhance the technical and institutional capacity of countries in need so that the proposal can be easily adopted by them.
- Integrate the new proposal with existing international green financing initiatives.
- Set up a common framework for monitoring and supervising the proposal with a focus on growth while minimizing the systemic risks of such an instrument.
- Encourage active engagement and regular communication with all stakeholders involved, including policymakers, international standard-setting bodies and the private sector.

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