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Challenges of implementing the NDC 3.0 agenda and the role of Finance Ministries in mainstreaming climate action

CFMCA Asia-Pacific Regional Meeting

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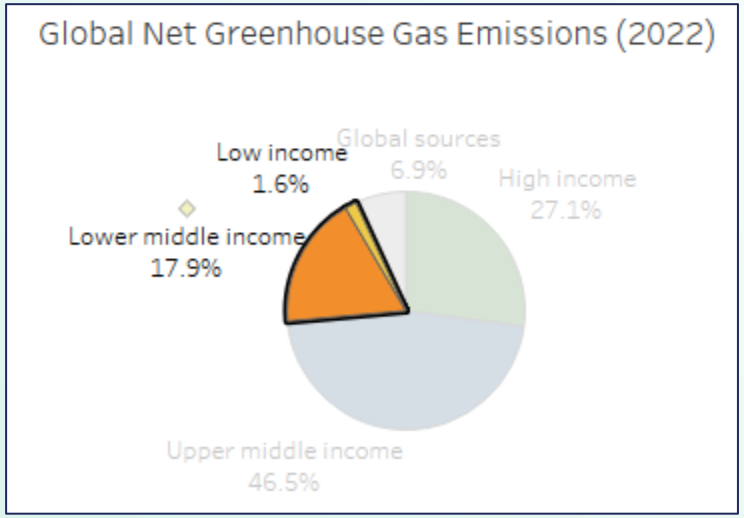
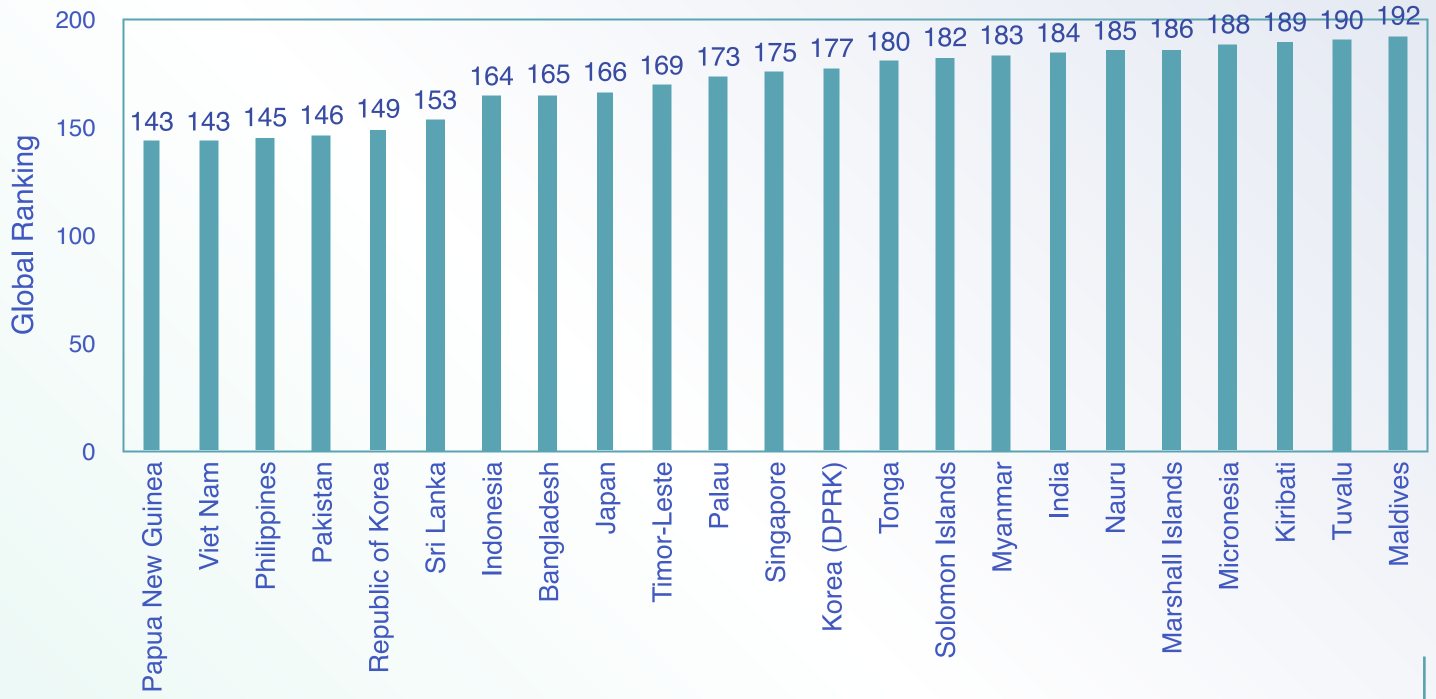
Key climate change issues facing EMDEs

- Low income (LIC) and lower middle income (LMIC) countries **contribute less than 20% of global GHG emissions**
- LIC and LMIC countries are highly vulnerable to climate change- **23 countries in the Asia-Pacific region are among the world's 50 most climate-vulnerable nations**



ND-GAIN index of exposure to damage from climate change

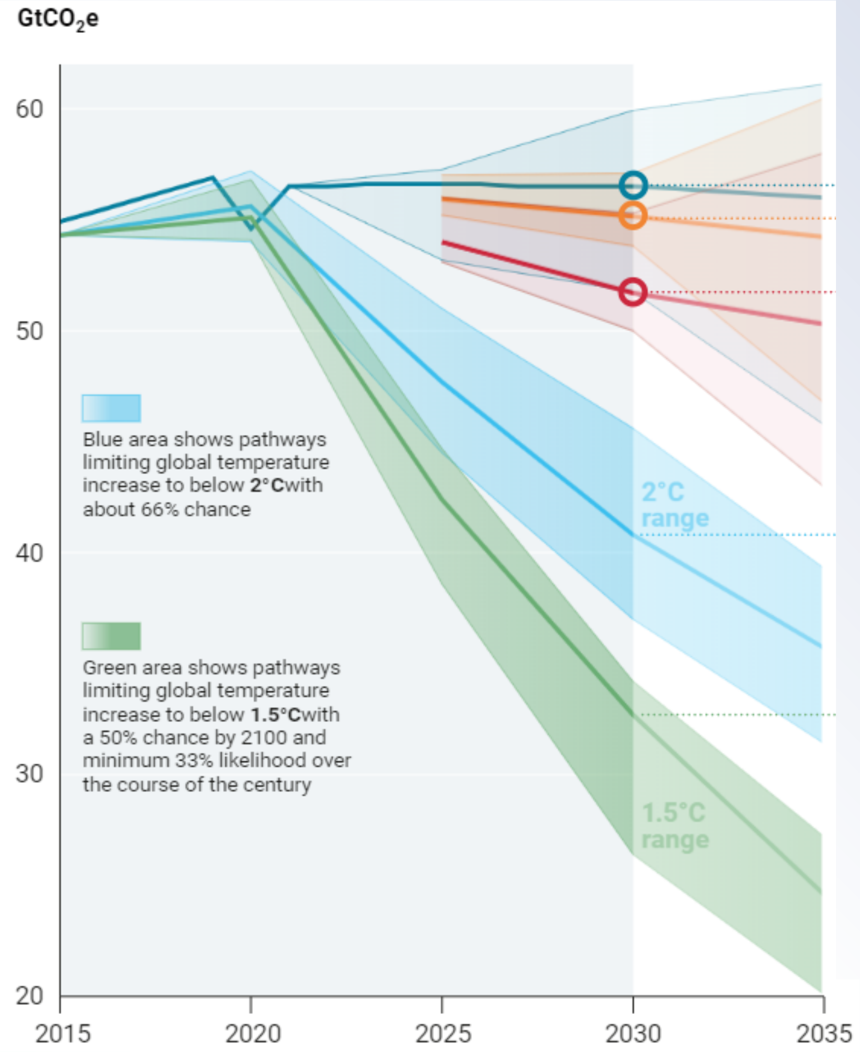


Facilitating country transitions has never been more urgent

Emissions are still rising; commitments are not sufficient. Recent Global Stocktake shows we are significantly off-track to achieve the Paris Agreement goals.

Countries need to enhance the ambition of their short-term (NDC) and long-term (LTS) climate commitments. **NDCs 3.0 are due early 2025, less than a year from now.**

Transitioning to resilient, net-zero economies is possible (and beneficial), but it requires **increasing ambition, strengthening capacity of institutions, and making major policy reforms.**



Opportunities, Needs, and Barriers

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Countries need to prioritize adaptation and resilience to climate change. Their vulnerability to climate hazards like floods, tropical cyclones, and sea-level rise is significant, and the economic costs of inaction are staggering.

Out of 57 EMDEs, 31 LICs and LMICs have developed NAPs for adaptation.

Many countries lack sufficient financial and technical resources to fully address their specific climate change related challenges. Scale of these challenges is large in relation to the size of their (small) economies.

Key strategic priorities for these countries are:

- investment in cost effective adaptation projects (e.g., flood defences); low-emissions transition projects (e.g., electrification via renewable energy, clean cooking)
- ensuring access to external natural disaster insurance to fund relief and recovery when disasters inevitably happen (ADB's Contingent Disaster Financing and World Bank's CAT DDOs are examples of disaster insurance instruments)

Most climate action will be implemented through the government budget

- ✓ The vast majority of finance for climate action in developing economies, especially LICs, LMICs and SIDSs, is mobilized from public sources (public revenue and grants or borrowing).
- ✓ Most of these countries have a small formal private sector, attract very little external private finance and have shallow domestic financial sectors.
- ✓ Most adaptation projects are pure public goods which are not suited for commercial investment (because they do not generate private returns which can be captured by commercial investors).
- ✓ Hence the government budget is by far the most important tool for implementing climate action in these countries.
- ✓ The key role of the government budget puts ministries of finance at the centre of planning and implementing climate action.

Key components for mainstreaming climate action into the budget

The next slide illustrates how key components of the policy making process are linked to mainstream climate action into the budget.

1. The NDC is guided by **the strategic developmental priorities** set out in the country's National Development Plan and by the fiscal space available in the medium-long term fiscal framework.

2. The NDC guides **the more detailed strategies**, including costed projects, which are set out in the LTS and NAP.

3. The LTS and NAP **influence sector development plans** where applicable.

4. The LTS, NAP and sector development plans **provide spending proposals for the budget process**, with broad sectoral allocations of budget resources also guided by the NDP.

Key components for mainstreaming climate action into the budget

National Development Plan

NDC

LTS & NAP

Other sector development plans
Integrate climate where relevant

National Budget Process

- Medium-Long Term Fiscal Framework to determine fiscal space
- High-level decision-making process to allocate resources among CA and other expenditure priorities
- Rigorous project selection and appraisal process to determine which CA projects are included in the budget
- Fiscal risk analysis

Mainstreaming Climate Action into the Budget Process

Key strategic policy objectives for Ministries of Finance

1. Ensure that expenditures on/financing of climate action is consistent with long-run macro-fiscal sustainability

2. Balance public expenditures on climate action with other competing demands for public expenditure

3. Ensure that budget resources allocated to climate action are used in the most efficient way possible i.e. they generate the highest social returns

How can these objectives be achieved in practice?

Learning from previous budget reforms

- **Mainstreaming climate action** into the budget process should build on the **foundations of policy based/program budgeting**.

- Since the 2000s, many EMDEs, including LICs, reformed their budget processes to align budget expenditures with strategic budget policies within a medium term framework.

- The **institutional apparatus of policy based budgeting** – medium term fiscal frameworks, MTEFs with sector expenditure ceilings, strategic plans for priority sectors – can be effectively used to help integrate climate action into the budget.

- Climate action can be treated as a strategic sector, with the LTSs and NAPs as strategic sector plans. **Climate action is not a stand alone sector:** many climate actions must be implemented by other sectors (e.g. making roads more resilient to flooding). Hence climate action also must be integrated into other sector plans.

Ensuring consistency with macro-fiscal stability

A **medium-long term fiscal framework is the essential starting point**, which entails projected fiscal deficits/public borrowing consistent with public debt sustainability and other macro-fiscal constraints (e.g. for the BOP).

Within this fiscal framework, **fiscal space analysis can be used to determine the maximum volume of public resources** for climate action, or other competing priority expenditures, over the medium to long term.

Each country's NDC submission should be formulated within this framework; i.e. the requirements of the NDC commitments for public expenditure must be:

i. fully and realistically costed, and
ii. in aggregate they must respect the projected budget resources available for climate action.

If that is not the case, it will not be possible to implement the NDC commitments fully and, as a guide to strategic planning, thy will have little value.

How should scarce budget resources be allocated between climate action and other competing priorities?

Expenditures on climate action compete for resources with other strategic budget priorities (e.g. , health). How much of the budget resource envelope should be allocated to climate action will depend on each country's national priorities. Clear criteria are also needed for determining how much is allocated to mitigation and how much to adaptation.

To determine this rationally, a high-level institutional decision-making mechanism within the medium-term budget planning process, which commands political support, is needed. This process should be guided by a medium-long-term National Development Plan (NDP) in which mitigation and adaptation are integrated, with some broad estimates of the cost of all development priorities reflecting NDCs

This is often the most challenging component of the budget process, because it involves a difficult balancing of technocratic and political imperatives.

Challenges for Ministries of Finance to mainstream policy objectives into budget expenditures

- Ministries of Finance and line ministries should coordinate and prepare a realistic pipeline of investable climate action projects that could be accommodated in the budget over the medium to long term.
- The projects should be ranked according to how well they meet policy priorities and subjected to rigorous CBA.
- Many climate change adaptation projects are more challenging for budget planners to evaluate than standard public investment projects. This is because the benefits (avoidance of damage from climate change) occurs over long time horizons and is often subject to a great deal of uncertainty.
- Finance ministries and/or line ministries will need to develop technical capacities for evaluating and quantifying highly uncertain benefits of adaptation projects to ensure that scarce resources are spent in the most effective manner.

Managing the fiscal risks of climate change

- Both the transition risks and physical risks of climate change could threaten future fiscal sustainability.
- These risks should be included in fiscal risk analysis undertaken by Finance Ministries.
- Some of the transition risks can be mitigated, if they are properly understood, through policy actions; e.g. by avoiding incurring contingent fiscal liabilities.

Conclusions and Implications for NDC 3.0

- ➢ If the NDC 3.0 commitments are to be realizable, it is essential that Finance Ministries participate in the decisions and ensure that they are cost-effective and feasible given the fiscal space available in medium-long term fiscal frameworks and other expenditure priorities.
- ➢ NDCs should be country specific and tailored to National Development Plans, capacities, and national and subnational priorities.
- ➢ LTSs and NAPs are essential to link the NDC commitments with the budget planning process; they can serve as sector development plans in a policy-based budgeting framework.
- ➢ For most EMDEs, especially LCs, LMICs and SIDSs, The costs of implementing their NDC 3.0 commitments will be borne mainly by the government sources.
- ➢ The budget process should be adapted to incorporate a rigorous process to determine how much budget resources can be allocated to climate action, the respective allocations to adaptation and mitigation, and which projects deserve to be prioritized for inclusion in the budget.
- ➢ Mainstreaming climate action into the budget has both political and technical challenges; political support is required to determine the size of the share of scarce budget resources which should be allocated to climate action and stronger technical skills will be needed to properly evaluate the long term, often uncertain, benefits of adaptation projects as well as to analyze and manage long term fiscal risks of climate change.