International Institute for Sustainable Development

SUBMISSION FOR THE FOURTH FINANCING FOR DEVELOPMENT CONFERENCE

Towards a Coherent, Transformative Approach to Financing Sustainable Development, Climate and Nature

By Alexandra Readhead, Anahí Wiedenbrüg, David Uzsoki
October 2024

Introduction

The financing needs of developing countries are staggering. The estimates keep piling up, with an extra USD 3.9 to 4.3 trillion per year to meet the Sustainable Development Goals (SDGs), including USD 1 trillion in external finance by 2030 to address climate change, and USD 700 billion per year until 2030 to preserve global biodiversity. The reality is that separate pots of money to fund these goals simply do not exist, and without an integrated approach to sustainable development finance, we risk competing for resources. The Fourth Financing for Development Conference (FfD4) is an opportunity to pursue a more coherent and ultimately transformative approach to sustainable development finance. We propose four ways to achieve this.

First, FfD4 should produce a cross-disciplinary review of the financing strategies required to meet all climate, nature and sustainable development goals. It could do so by convening the expert communities associated with the different financing frameworks to review how the frameworks propose to meet the financing required, how their estimates are done, and how they could join up to achieve their common objectives. These frameworks include the Addis Ababa Action Agenda, UNDP Integrated National Financing Framework (INFFs), the

Climate Finance Framework announced at COP28, and most recently the strategy for biodiversity finance in the Global Biodiversity Framework (GBF). There is considerable work to do to bring these communities together to identify overlaps, gaps, and inconsistencies, and to inform a more coherent, mutually reinforcing approach going forward.

Second, FfD4 should strike a grander bargain on sovereign debt relief as an essential complement to domestic resource mobilization (DRM) targets.[1] As it is now, achieving meaningful progress on sustainable development and climate depends primarily on countries increasing DRM.[2] For the Climate Finance Framework this is USD 1.4 billion of the total USD 2.4 billion required for climate and nature-related spending. Overseas Development Assistance (ODA) and concessional finance, on the other hand, remain limited.[3] For many developing countries who have lower emissions and are bearing the brunt of climate change, the focus on DRM may be a bitter pill to swallow. This is one of several reasons why meaningful progress on external debt relief must be a key part of FfD4. It is a pre-condition for development finance to be effective, and crucial to ensuring a more just and equitable framework.

Third, FfD4 needs to define practical guidance to policymakers on the 'how' of DRM. Many of the frameworks propose specific reforms such as carbon taxes, elimination of harmful subsidies, and debt restructuring. However, there is little guidance on what the right package of measures is, in different contexts, including sequencing, hierarchy of reforms and navigating trade-offs both universally and in specific circumstances. For example, there may be limited value in rolling out a carbon tax in countries with high fossil fuel subsidies, because they cancel each other out. Similarly, providing finance to countries in (or in high risk of) debt distress without restoring their debt sustainability first would only result in more debt to meet existing debt obligations, without increasing their fiscal space to make development and climate investments. Likewise, giving guarantees to 'de-risk' private finance could result in further indebtedness through contingent liabilities, if the risks are outside governments' control. The different components of DRM and external debt, and their interaction with private finance, should be viewed holistically, and the order and logic of policy choices hammered out for optimal results.

[1] We define debt relief to include both debt operations with principal reductions for countries whose debts are unsustainable and meaningful rollovers for those capable of keeping their debt servicing commitments.
[2] The IMF and World Bank define DRM as including public revenues, primarily taxes, efficiency gains from public procurement, and domestic debt.
[3] Bilateral and innovative concessional finance makes up USD 150 to 200 million of the USD 1 billion in external finance for climate and nature related spending requirements.

Finally, FfD4 should foster greater coordination between development, climate and nature finance communities through multi-stakeholder spaces. Several multi-stakeholder financing platforms exist, or will in the near future, where multilateral institutions support policies and institutional reforms based on a country-led and owned approach to DRM and external financing, aligning it with national strategies and goals. These include country-platforms, as well as the recently launched Joint Domestic Resource Mobilization Initiative (JDRMI) of the World Bank and the IMF. FfD4 should draw on lessons learned from the implementation of these multi-stakeholder coordination and integration spaces to inform the design of future initiatives. In particular, leveraging these platforms to enhance transparency of revenue estimates and investment and financing needs.

Discussion

Our submission begins to explore several questions regarding overlaps, gaps, and inconsistencies between the different financing frameworks, options for transformative debt relief, effective strategies for DRM, and interactions with private finance initiatives. Answers to these questions should drive the agenda for FfD4, and a more coherent approach to financing sustainable development, climate and nature goals going forward.

1. What overlaps, gaps and inconsistencies exist between the different frameworks for financing development, climate and nature?

Several financing frameworks have emerged since the Addis Ababa Action Agenda in 2015. There is the UNDP Integrated National Financing Framework (INFFs), the Climate Finance Framework (CFF) announced at COP28, and most recently the strategy for biodiversity finance in the Global Biodiversity Framework (GBF). The United Nations (UN) has also proposed a new Framework Convention on International Tax which prioritizes several interventions aimed at rebalancing taxing rights and increasing domestic revenue collection. Lastly, there is a new Global Solidarity Levies Taskforce focused on identifying new potential sources of revenue for climate action. A high-level analysis of these frameworks reveals how the challenges and opportunities for sustainable development finance have evolved over time, and how this is likely to shape FfD4. Three key developments can be observed.

The first relates to the increase in income and wealth inequality in recent decades. Rising inequality is at the heart of the social discontent, political polarisation and populist nationalism evident in many countries today. An increasingly unequal society threatens democratic governance and geopolitical stability making it a major public policy concern. On the tax front, there is a clear and strong demand from civil society organizations for tax justice. How much in tax wealthy individuals contribute to their countries is becoming an ethical question of broad public interest. Ideas that used to be considered marginal, such as wealth taxes are now being considered by the G20. On the debt front, how countries limited fiscal space is used to meet their distinct obligations vis-a-vis their different constituencies – citizens on the one hand, and different creditor classes on the other - is also heatedly debated. More attention has been paid to the continued outflow of funds for the servicing of private debt and non-Paris Club debt, that to the status of investments in education, health and infrastructure, that are indefinitely postponed. FfD4 will need to explicitly address the link between tax, debt, and inequality to respond to current social concerns.

The second is the rise in sovereign debt globally. While a widespread debt crisis has been averted, the proportion of poor countries in debt distress, or at high risk of debt distress, has risen, increasing from 22 percent a decade ago to almost 60 percent today. Governments spent 10% of public revenues servicing their debt in 2022 – diverting vital resources away from sustainable development and climate action. This is compounded by non-concessional climate finance leading heavily indebted poor countries to become even more indebted. While debt features in the Addis Agenda, it is largely from the perspective of keeping debt sustainable, rather than the systemic and structural debt relief required today. The CFF makes debt relief a necessary pre-condition for countries to finance their climate goals even for those not facing sustainability, but 'solely' a liquidity crisis. Simply put, "countries with liquidity crises cannot attract private capital inflows needed to finance climate goals." The same can be said for sustainable development generally, making it vital that proposals for debt relief feature prominently in FfD4, and that FfD4 is used as an opportunity to tie different conversations and initiatives relating to debt relief together, along with continued efforts to improve debt management and sustainability.

The third is the urgent need to address the climate and nature crises. A changing climate, and the measures required to limit its severity or cope with its impact, are already putting a heavy burden on governments around the world, particularly in developing countries. Freeing up fiscal space to respond to both crises is vital. The Addis Agenda highlights the importance of fiscal measures to address climate change, leaving the United Nations Framework Convention on Climate Change (UNFCCC) to determine the details. The CFF is, unsurprisingly, more prescriptive about such fiscal measures proposing carbon taxes, the reform of environmentally harmful subsidies, climate conditional debt relief, and Climate Resilient Debt Clauses. The UN has identified environmental taxation as potential protocol of the UN Convention on Tax. While clear mandates are important, the scale and urgency of the climate and nature crises and their impact on sustainable development makes the separation between financing frameworks increasingly artificial. It exacerbates the disconnect between the expert communities and risks them developing a myopic view of financing based on what is or is not 'counted' under certain agreements. FfD4 should close the gap between the development, climate, and nature finance communities, and propose mechanisms to enhance coherence between the frameworks.

There are several policy recommendations that are consistent across the financing frameworks, although often with different starting points, making coordination particularly important to avoid undermining efforts. One area is tax incentives. All the frameworks, except the GBF, which is less prescriptive, identify tax incentives as a major source of revenue loss requiring urgent attention. The IMF estimates that developing countries' tax-to-GDP ratios could increase by 9 percents through a combination of incentives reform and institutional capacity building. The CFF highlights the role of the Global Minimum Tax in enabling incentives reform. While there is growing momentum to rationalise incentives, there is also an urgent need to attract private finance to achieve climate and biodiversity goals. In some cases, this is leading to a push for "green incentives" to promote investment in clean energy technologies, for example. While there may be a role for green incentives, the impact on revenues must be carefully analysed. FfD4 must navigate the tension between promoting the fiscal space required for adaptation, and attracting the investment required for the low carbon transition.

Sovereign debt relief is another area where a shared understanding of the end goal is required across financing frameworks and their expert communities. Debt swaps have generated considerable interest amongst climate and nature finance communities. These instruments have been proposed as a way to help countries deal with both climate and debt problems at the same time. The appeal of swaps is intuitive: if we face both a debt and a climate crisis, why not contributing to their resolution by tackling them together? Swaps can work in some cases and free up much needed resources, but alone they cannot solve either the debt or climate crisis. Instead, ambitious debt relief must be the goal. But focussing on swaps in certain international fora means we are not talking about other more comprehensive proposals such as the initiative for Debt Relief for Green and Inclusive Recovery or the Bridge Proposal.[4] These

[4] The latter has found its way into the G20 agenda, as a proposal made by individual Paris Club creditors.

specific debt instruments must be put in a broader context to ensure that they add to, rather than distract from the ultimate goal of making the international debt architecture fit for purpose.

2. What should a grander bargain on debt look like in the context of FfD4?

Sustainable external debt finance is an essential complement to DRM.[5] Were it not for debt, governments' ability to invest would be limited by their actual fiscal space, which is currently very limited. Given the magnitude of the investment needed for developing countries to meet their development and climate goals, access to credit is thus vital. A grander bargain on sovereign debt would provide the right incentives for debtors and creditors alike, ensuring debt sustainability is restored in an equitable and efficient way, and creating fiscal space for necessary investments. To achieve this, progress is required on at least three fronts: technical, political, and governance.

On the technical level, we need to build consensus around a reform proposal. The initiatives which are getting the most attention at the G20 are the Bridge Proposal and the Debt Relief for a Green and Inclusive Recovery Proposal (the former more than the latter). Both involve three pillars: debt relief from official creditors and from private creditors, credit enhancement from multilaterals, and a commitment from the debtor country to use the fiscal space created for recovery green growth. The main difference is that whereas the Bridge Proposal targets countries facing liquidity constraints, but whose debt remains sustainable (thereby complementing the Common Framework for Debt Treatment (CF)), the latter seeks to revise the CF, not only expanding it to Middle Income Countries, but also by anchoring it in a Debt Sustainability Analysis (DSA), which takes climate risks and investment needs for climate and development into account. Continued conversations are needed on how to build on the proposals' strengths and overcome their respective weaknesses. The role of FfD4 here should be to increase pressure on the right actors (see political level) and at the right fora (see governance level) to advance these technical discussions, and to make these conversations more accessible to a broader stakeholder group, including civil society from debtor and creditor countries alike.

On the political level, we need to ramp up momentum for ambitious debt relief. Despite of its limited success and shortcomings, adopting the CF during the pandemic was a diplomatic success, as it succeeded in establishing a framework for Paris and non-Paris club creditors alike, to commit to a set of shared debt restructuring norms. Since then, however, political will to push through additional reforms has been limited and the generation of new

[5] Debt is external if both debtor and creditor are not residents of the same country.

common norms around debt restructurings has been outsourced to the Global Sovereign Debt Roundtable (GSDR), established in 2023. The GSDR, however, is neither a representative, nor a political forum, and thus not the right place to build consensus for a more ambitious debt relief initiative. The FfD4 is a unique opportunity to enhance pressure on bilateral creditors of G20 countries to prioritize the adoption of a more ambitious debt relief initiative.

On the governance level, we need to decide on the forum where such an initiative is to be discussed. This brings us to the last level at which FfD4 should seek to generate consensus, namely the governance level. Where should a more ambitious debt relief initiative be adopted? If the recent track record and the current division of labor between international fora is respected, the more obvious choice would be the G20. But it is not the only choice, and in the past, calls for the establishment of multilateral frameworks at the United Nations have gained significant traction. What is clear is that the answers found on the respective levels - the technical, the political and the governance level – condition each other and thus finding an answer to the question of where the debt relief initiative ought to be established, will impact its nature.

3. What are the different components of a strategy to sustainably increase DRM? What specific policy options exist within each component? How do these options interact?

While there are several financing frameworks in existence, few get to the "how" of development finance, specifically DRM.[6] FfD4 needs to provide concrete pathways to DRM strategies, including the trade-offs between different policy options, and the sequencing of reforms. This toolkit will help countries make informed choices between different options. There are three main sources of DRM: a) public revenues, tax being the main component; b) efficiency gains from public procurement; and c) government borrowing in domestic debt markets. We focus on a two areas of tax reform that standout.

The first is strengthening domestic taxation, and rationalizing tax incentives. For the last decade or more, the tax community has been pre-occupied with international taxation – the Tax Base Erosion and Profit Shifting (BEPS) Agenda, the Pillar I and Pillar II global tax reforms, and now the UN Convention on Tax. While important, this focus has taken resources and time away from domestic tax reforms that arguably yield greater revenue gains for developing countries. Domestic tax reforms should focus on more effective taxation of natural resources, particularly the critical minerals required to power the energy transition; rationalising tax incentives, including in Special Economic Zones; and broadening the tax base through Value-Added-Taxes (VAT), property taxes, and potentially wealth taxes. Efforts to improve or identify new sources of international tax should not be abandoned – renegotiating tax treaties, taxing offshore indirect transfers, and new climate-related taxes on shipping or aviation – but FfD4 should insist on more time, technical assistance, and finance being allocated to strengthening domestic tax policy and tax administration.

The second is environmental tax reform – not because it is a major source of revenue – but because it poses questions for ordering and and trade-offs. There are several ways of approaching environmental tax reform. The two most discussed are reforming fossil fuel subsidies, and carbon taxes. Fossil fuel subsidies cost us well over USD trillion globally, making subsidy reform a significant source of potential revenue. However, the politics of subsidy reform has meant that progress has been slow. The flipside of 'bad' subsidies is 'good' subsidies that incentivise investment in clean energy technologies, although as highlighted earlier in the document these instruments need to be carefully evaluated in terms of the impact on public funds. Putting a price on carbon is gaining momentum through various regional and national approaches. Of course, there is limited value in introducing a carbon tax if fossil fuel subsidies remain. However, not all developing country governments see carbon taxes as a priority. Those with lower emissions may prefer to contribute to addressing environmental issues by taxing pollution, plastics, or deforestation. There is significant appetite amongst developing countries for introducing environmental taxes, but many governments lack an understanding of what environmental taxes are, and how to implement them. FfD4 should avoid a one-size-fits all approach to environmental tax and encourage contextually appropriate approaches.

4. What policies would countries need to put in place to mobilize and allocate efficiently private sources of financing? How do private finance initiatives interact with public finance goals?

Private capital, both domestic and international, is an important complement to DRM and external debt. Given the scale of financing needs and the limited fiscal space of many governments due to high debt levels, public resources alone are insufficient. The Addis Ababa Action Agenda and subsequent frameworks recognize the critical role of private finance in bridging this gap. To mobilize and allocate private capital effectively, countries must create an enabling environment that fosters private investment, while protecting what fiscal space they do have. This includes developing robust domestic debt markets supported by a strong institutional investor base, such as pension funds and insurance companies. These institutions can provide steady demand for project bonds that finance sustainable infrastructure and other types of revenue-generating projects needed across different frameworks.

To attract private investment, governments can use de-risking strategies to make projects more appealing to private capital. This may involve providing guarantees to mitigate specific project risks, such as credit risk, or offering subordinated capital that serves as a risk buffer for more senior tranches of financing provided by investors. At the same time, it is important to acknowledge that these de-risking measures can have negative impacts on public finances. They create contingent liabilities for the government, and if the guarantee is triggered or the project underperforms, the government is obligated to cover the losses, which can strain fiscal resources and potentially increase public debt levels. This is particularly concerning for countries already facing high debt burdens, as it can exacerbate fiscal vulnerabilities and limit the government's ability to invest in other critical areas of sustainable development. FfD4 must carefully examine the interaction and trade-offs between private and public finance – balancing the need to leverage limited public resources to catalyze private investment, while protecting tax revenues and maintaining debt sustainability. Implementing clear guidelines and limits on guarantees, conducting cost-benefit analyses, and ensuring transparency can help mitigate these risks.

Conclusion

On process, we recommend that FfD4 take stock of the frameworks for financing development, climate and nature, to identify overlaps, gaps and inconsistencies in approaches, and bring expert communities together to develop mechanisms to promote coherence. On content, we recommend that external debt relief be the key contribution of FfD4. It is a necessary pre-condition for attracting investment, absorbing finance, and achieving a fairer financing framework. We also consider that FfD4 should spend more time elaborating the 'how' of DRM including what the right package of measures is, in different contexts, including sequencing, hierarchy of reforms and navigating trade-offs. Finally, it is important that any proposals to attract private capital are consistent with, and mutually reinforce, public finance goals.

Published by the International Institute for Sustainable Development

Head Office

111 Lombard Avenue, Suite 325
Winnipeg, Manitoba
Canada R3B 0T4

Tel: +1 (204) 958-7700
Website: www.iisd.org
Twitter: @IISD_news

IISD

IISD.ORG