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Climate-Smart Fiscal Policy Can Foster a Lasting Economic Recovery

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The recession and debt distress accompanying coronavirus disease 2019 (COVID-19) pose serious threats to governments’ ability to invest in achieving the Sustainable Development Goals, raising the specter of another lost decade for climate action. However, fiscal policy can be designed to simultaneously stabilize the economy and public finances while advancing sustainable development.

As countries fight the spread of coronavirus disease 2019 (COVID-19), the global economy is shrinking while countries face record public-debt levels. Countries are incurring large fiscal losses—either from stimulus measures or from upholding essential state functions during the pandemic. Tax revenues are collapsing, eating up fiscal space at a rapid pace. To make matters worse, many low-income countries were already at risk of debt distress before the pandemic began.

Meanwhile, environmental factors now account for eight of the ten most likely and highest-impact global risks, according to the World Economic Forum. The year 2020 is on course for being the hottest ever, and the pandemic itself has been attributed in part to environmental causes.

These macroeconomic and environmental pressures constitute both an immediate and a long-term danger, demanding forward-looking policies even in the rush to address the COVID-19 crisis. In this situation, Finance Ministers have a crucial role in choosing the right mix of fiscal policy that can lay the foundation for sustainable growth and more resilient economies, while alleviating economic hardship, especially for the poor.

In the recovery phase, once stability is achieved, countries will need to rebuild fiscal space, which is exceptionally hard in the aftermath of recessions. After the 2008 global financial crisis, efforts to rebuild fiscal space—by raising taxes or cutting expenditures—contributed to double-dip recessions and persistent losses of human capital, increased income inequality, and fractured social cohesion. Many countries also delayed climate mitigation efforts, disrupting the path to sustainable growth. Such policy errors should not be repeated. Now, more than ever, countries need to choose fiscal measures carefully, balancing short-term stabilization objectives with long-term economic sustainability.

Achieving the Right Balance
The prospect of tight public finances persisting in developing and donor countries even after the COVID-19 crisis abates is a significant threat to the Sustainable Development Goals (SDGs). If macroeconomic constraints affecting the public purse over the coming decade undermine the delivery of the SDGs, the consequences could be severe, including for global macroeconomic stability itself.

Consider the rising danger of climate change. There is an overwhelming economic case for stabilizing global warming at 1.5 °C, and the window to do so is narrowing rapidly, with less than 10 years to keep CO2 concentration within tenable levels. For the poorest 40% of countries, it is estimated that global warming has already taken a significant toll: without climate change, GDP growth would have been 17%–31% higher between 1961–2010. By the end of the 21st century, climate change could shave off another 75% of GDP. Business-as-usual emissions could increase the number of poor people by 122 million by 2030 and internal migrants by 143 million by 2050. Climate-related disruption of asset prices is widely expected to cause future financial crises. Solutions must therefore be found to achieving the SDGs, including climate-change mitigation, despite the stark deterioration in public finances.

Fortunately, there is an emerging consensus on the necessity of confronting these challenges jointly. 62 central banks, financial-sector regulators, and international organizations, including the World Bank, agree: “The economic response to the pandemic should not be to rebuild the old economy with the climate risks it presents, but to act now to lay the groundwork for an orderly transition to a more sustainable economy and climate-resilient financial system—a ‘green’ recovery.” Similarly, 53 finance ministers have joined together in the Coalition of Finance Ministers for Climate Action—launched at the World Bank in April 2019—to integrate climate considerations into fiscal and macroeconomic policy.

Fiscal Policy Options for Building Back Better
One solution for combining fiscal and environmental sustainability is to shift the time profile of indispensable SDG investments. Instead of waiting a few years to invest in the infrastructure that will be needed to lower carbon emissions, finance ministries should incorporate these expenditures into current stimulus packages. Frontloading inevitable investments can help stabilize the economy now, reduce investment needs during the coming austerity period, and help achieving climate targets.

Finance ministries should prioritize investments with the greatest synergies for short-term macroeconomic stabilization. Many climate investments, for example, for renewable energy or...
resilient infrastructure, have long been planned in countries’ national climate strategies (Nationally Determined Contributions, or NDCs), which most countries are presently updating, providing a further opportunity to align them with the economic recovery. Activating these investment plans now can have large, long-term macroeconomic benefits. As a recent survey of 230 finance ministry and central bank officials suggests, green investments can have a larger impact on GDP and on employment growth (owing to their often-deeper labor content) than emissions-intensive investments.11

Taking advantage of the crash in global fuel prices is another option. Coal, oil, and natural gas prices are now far below their long-term averages and projected to stay low for much of the decade. Expectations of prolonged low fuel prices undermine private-sector incentives to invest in low-carbon industries. In fact, the price drop provides an implicit subsidy to fuel-intensive industries and wealthy households that tend to consume more fuel than the poorer households.12 Governments could instead hold fossil fuel prices stable through increased fuel taxes or reduced subsidies. They could use the extra revenue for a broader fiscal stimulus that benefits firms and households more evenly. North Macedonia, for example, is currently raising fuel prices to finance new public investments. Sweden and the Canadian province of British Columbia used revenues from additional taxes on fuels to reduce economy-wide income taxes inhibiting growth during the 1991 and 2008 recessions. Spreading captured revenues more evenly across industries and households can lead to better economic and social outcomes. This is an opportunity especially for developing countries that may not otherwise be able to afford a broader fiscal stimulus in a revenue-neutral manner.

Fiscal policies that combine green investments with fuel taxation can lead to a compounded multiplier effect. With any stimulus program, the role of public investment is not just to directly stabilize the economy but also to align market expectations on the recovery and crowd-in private investment. The same is true for green stimulus programs. They are most effective if public investment enables business opportunities, so the private sector co-invests in the sustainability transition. For climate-related investment, these business opportunities strongly depend on the relative prices of green and polluting sources of energy, determined by the domestic fuel tax/subsidy regime. As a result, capturing windfall gains from falling fossil fuel prices not only provides revenues for broader stimulus, but also raises the ability of finance ministries to “crowd-in” private-sector co-financing to green public investment, even if the fuel tax revenues are not earmarked for the green investments.

**Environmental Taxes Can Help Rebuild Fiscal Space**

Raising environmental taxes can also help countries rebuild fiscal space. It broadens tax bases at a time when traditional revenue sources have dwindled. A principle of growth-oriented tax policy suggests countries should have wide tax bases with low nominal tax rates. The tax system is less distorting if economic activities are taxed evenly instead of exempting one and taxing the other at high rates. This is difficult to achieve in developing countries with large informal sectors that are hard to cover with conventional taxes. As a result, many developing countries impose high nominal tax rates on a narrow formal-sector tax base—such as the small subset of the workforce that is formally employed by large companies or the state.

There is evidence that such uneven taxation encourages tax evasion and informality, contributing to slower productivity growth. More generally, evidence suggests that in many countries shifting the structure of tax revenues away from income taxes toward consumption and excise taxes can raise growth, especially when the reform removes exemptions instead of raising nominal rates. In applying this strategy, one excise tax stands out: carbon taxation. Taxing carbon is not only the most effective way to curb carbon emissions, it is also a large and mostly unused tax base—a massive exemption, contradicting the principle. To achieve the Paris Agreement’s goals, a carbon tax amounting to a global average of $75 per metric ton of CO₂ is needed by 2030.13 This could raise between 0.5% to 3% of GDP in national tax revenues and help fund fiscal consolidation or post-COVID expenditures such as shoring-up hard-hit healthcare systems (Figure 1).

Raising revenues through carbon taxes has other desirable characteristics compared with other bases. Upstream carbon taxes can cover the informal sector, with low administration costs and few opportunities for evasion, and can have more benign impacts on employment and output than raising additional revenues through labor and corporate taxes.14 Carbon taxes also have broader development benefits. By reducing hazardous air pollutants like fine particulates co-emitted with fossil fuels, carbon taxes improve local air quality, which could help tackle the 3 million premature deaths from ambient air pollution in developing countries per year. For these reasons and others, economists are increasingly calling for carbon taxes, including 27 Nobel Laureates last year.15 It is high time for finance ministries to heed their advice and support fiscal, macroeconomic, and sustainability objectives jointly.

**The Right Moment for Policy Action**

Raising fuel prices above consumer expectations can be politically difficult. But merely holding fuel prices stable at the past levels that consumers have become used to would raise significant revenues. Diverting revenues from fuel-price windfalls into economy-wide stimulus or social-support programs would broaden the political base for reform. Eliminating fossil-fuel subsidies during low-price times is an attractive way to capture resources without hurting the most vulnerable (whose consumption can be boosted more efficiently by direct transfers). For political economy reasons, now is the time to do so.

If policymakers would like to avoid any near-term tax increases, it is still possible to stimulate green private investment today by signaling future policy changes. A green investment program’s effectiveness at crowding in private finance is enhanced when the private sector expects future green-business opportunities. Businesses make investment decisions based on expectations of future prices. So instead of tightening fiscal policy on fuels today,
policymakers could commit to a schedule of future tax increases to create positive expectations for the future viability of green sectors.

For example, Switzerland has adopted a legislative framework specifying that carbon taxes will be increased if emission targets are not met. Canada has written into law the gradual increase of minimum carbon prices well into the future. When governments take credible actions, the private sector faces a strong incentive to invest in low-carbon industries despite today’s low fuel prices.

Other options are available to improve long-term sustainability without hurting today’s consumers. Many countries, from Cape Verde to China and Malaysia to Mexico, use fuel-price ceiling mechanisms to buffer the domestic economy against global fuel price hikes. However, these pricing controls discourage investments in energy efficiency and tend to be procyclical, subsidizing fuel consumption in good times. Normally, phasing out subsidies exposes the population to unexpectedly high fuel prices. But if fuel-price ceilings were abolished now that prices are so low, the impact on the consumer’s purse would be minimal. Such a reform will improve future fiscal space and remove a built-in source of fiscal procyclicality for many countries.

Looking Ahead
Given the intense short-term fiscal pressures created by the pandemic, there is a serious risk of fiscal-policy errors that could have lasting consequences. In the worst case, as it happened in the response to the 2008–2009 crisis, delaying action on rapidly escalating threats like climate change could mean going from one macro crisis to the next. But policymakers can avoid another “lost decade”. Climate-smart fiscal-policy measures would help set countries on a sustained and sustainable growth path. Doing so will go a long way to facilitating a more prosperous, cleaner, and equitable post-COVID world.

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