

TC Document

1. Basic Information for TC

▪ Country/Region:	REGIONAL
▪ TC Name:	Fiscal Policy and Climate Change
▪ TC Number:	RG-T3640
▪ Team Leader/Members:	Eguino, Huascar (IFD/FMM) Team Leader; Pimenta, Carlos Cesar (IFD/FMM) Alternate Team Leader; Alejos Marroquin, Luis Alejandro (IFD/FMM); Almeida, Juliana Salles (CSD/CCS); Ardanaz, Martin Jorge (IFD/FMM); Astudillo, Karen (IFD/FMM); Bonilla-Roth, Marcia E. (SRE/PFA); Cabrera Botero, Maria Margarita (CSD/CCS); Delgado, C. Raul (CSD/CCS); Gomez Reino, Juan Luis (IFD/FMM); Gonzalez Sosa, Nathalia (IFD/FMM); Harper, Leslie Elizabeth (IFD/FMM); Lopes Pereira De Melo, Aloisio (CSD/CCS); Lora Rocha, Oscar (IFD/FMM); Maria Cristina Mac Dowell (IFD/FMM); Murguia Baysse, Juan Manuel (CSD/RND); Negret Garrido, Cesar Andres (LEG/SGO); Rasteletti, Alejandro Gabriel (IFD/FMM); Reyes-Tagle, Gerardo (IFD/FMM)
▪ Taxonomy:	Research and Dissemination
▪ Operation Supported by the TC:	.
▪ Date of TC Abstract authorization:	14 Apr 2020 2020 2020
▪ Beneficiary:	Barbados, Brazil, Chile, Colombia, Costa Rica, Ecuador, Guatemala
▪ Executing Agency and contact name:	Inter-American Development Bank
▪ Donors providing funding:	NDC Pipeline Accelerator Multidonor Trust Fund(ACL); OC Strategic Development Program for Institutions(INS); OC Strategic Development Program for Sustainability(SUS)
▪ IDB Funding Requested:	NDC Pipeline Accelerator Multidonor Trust Fund (ACL): US\$250,000.00 OC Strategic Development Program for Institutions (INS): US\$250,000.00 OC Strategic Development Program for Sustainability (SUS): US\$120,000.00 Total: US\$620,000.00
▪ Local counterpart funding, if any:	US\$0
▪ Disbursement period (which includes Execution period):	24 months
▪ Required start date:	August 1, 2020
▪ Types of consultants:	Firms and individual consultants
▪ Prepared by Unit:	IFD/FMM-Fiscal Management Division
▪ Unit of Disbursement Responsibility:	IFD-Institutions for Development Sector
▪ TC included in Country Strategy (y/n):	No
▪ TC included in CPD (y/n):	No
▪ Alignment to the Update to the Institutional Strategy 2010-2020:	Institutional capacity and rule of law; Environmental sustainability

2. Objectives and Justification of the TC

- 2.1 **Objective:** Support the mainstreaming of climate change action (CC) within fiscal policies/management in potential countries¹ through: (i) development of standardized instruments and methodologies; (ii) mainstreaming adaptation and mitigation actions within fiscal policies and management systems; and (iii) strengthening the institutional capacity of the region's governments in the aforementioned topics.
- 2.2 **Justification:** The adoption of the Agenda 2030 for Sustainable Development and the Paris Agreement established an unprecedented international commitment to change our current economic and social models towards sustainable, resilient, and zero-carbon development. Under Article 2 of the Paris Agreement (PA), countries have committed to limit global temperature rise to well below 2°C above pre-industrial levels and to pursue efforts to limit the temperature increase to 1.5°C. These commitments are included in what are known as "nationally determined contributions" (NDCs), which in most Latin American and Caribbean (LAC) countries include actions to reduce carbon emissions and to address climate change impacts. Countries are also bound to submit a new iteration of NDCs in 2020, followed by updates every five years (2025): in LAC, only Chile and Suriname, have submitted this new information.
- 2.3 LAC represented 8.3% of the world's emissions (ECLAC, 2018), however, its relevance in climate action goes beyond the emission reduction potential. The achievement of country goals in its NDC, requires major policy changes, focusing on the promotion of national climate action through fiscal policies and the efficient use of public resources. A key aspect on reaching a more efficient public spending on climate change (currently at a level that varies between 0.27% to 2.24 % of Gross Domestic Product in LAC) is to adopt a standardized methodology of budget classification, as well as to track and evaluate related public expenditures.
- 2.4 In this context, the IDB seeks to support LAC countries in building up their institutional capacities to incorporate climate actions into fiscal policies and management processes. The Ministries of Finance play a key role in these tasks, as they could systematically support climate change actions in national budgets, public investment systems, procurement regulations, tax policies, amongst others, aimed to maximize the efficiency and effectiveness of public resources.
- 2.5 Several countries in the region need technical assistance to support the Ministries of Finance with new methodologies and tools to implement climate change initiatives towards reaching their NDCs. At the same time, the IDB is committed to increasing its climate finance in its operations in areas such as fiscal risks, budget management, public investment, taxation, and public procurement. Specifically, there is a need to support the development of new methodologies and tools to tackle important issues such as:
- **Assessing climate-related risks** (particularly those associated to natural disasters and the transition to greener economies) and quantify the associated contingent fiscal liabilities for strengthening countries' medium/long term fiscal sustainability. In LAC there has been an increase in the number of extreme weather events. On average, the frequency of extreme events per country increased from one every eight years for the period 1980-2000 to one every five years for 2001-2016. It is estimated that, between 2001 and 2016, the average

¹ Potential beneficiary countries include Barbados, Brazil, Chile, Colombia, Costa Rica, Ecuador, and Guatemala. These countries showed interest in implementing specific climate change actions related to fiscal policies with the Bank's support.

annual cost to the region's public finances of these events was between 0.2% and 0.3% of GDP, which represents more than 10% of the average fiscal deficit of the region (2.5% of GDP) during this period (Alejos, L. 2017)². In addition, as countries transition to a greener economy, there is a risk that fiscal revenues could be affected as alternative technologies become cheaper and oil demand slows down for several LAC countries. Given this context, it is important to support the LAC countries in developing methodologies and guidelines that allow them to know in greater detail the costs and fiscal risks and contingent liabilities associated with extreme natural events and the transition to greener economies, in order to improve the resilience of public finances in the medium and long term.

- **Adopting operational guidelines to tag climate change expenditures, track their execution, and assess their effectiveness.** The IDB seeks to develop these guidelines to support LAC countries in the implementation of climate expenditure tagging systems. It is expected that these standardized guidelines will contribute to improve transparency and decision-making on climate change related budget allocation. The development of the guidelines will take into consideration the progress made by some countries of the region, particularly the experiences of Colombia, Ecuador, Honduras, Nicaragua and Guatemala in budget tagging (Almeida, M. y Torres, A; 2020).³
- **Adopting guidelines for ex-ante evaluation of sustainable public investment.** Planning of public investment needs to incorporate norms and guidelines to foster sustainable infrastructure and incorporate climate change considerations within the ex-ante evaluation methodologies of public investment. LAC countries will have to invest about 5% of their GDP over the next 20-30 years (IDB, 2017). Improvements in the design and implementation of investment projects could reduce this amount by 40%. Potential gains fall into three categories: improving project selection and optimizing public investment portfolios (20% of total gains), streamlining delivery (40%), and making the most of existing assets (40%) (IDB, 2017). The inclusion of sustainable considerations on these categories is a critical factor to ensure that national public investment systems will contribute to NDCs and improve the quality of public expenditures. In the region Chile is leading in the effort of streamlining climate action in the ex-ante evaluation of public investment and its experience will be used for the development of the guidelines.
- **Guidelines to promote environmental taxes.** LAC countries need to introduce taxes and subsidies reforms to eliminate unnecessary fiscal expenses and set up incentives to reduce carbon emissions, avert negative externalities, and implement more equitable and sustainable fiscal policies. Over thirty years some OECD countries have been implementing different alternatives to introduce environmental tax instruments. There have been different experiences with taxes on pollution emissions, carbon and waste generation, and the use of pesticides and fertilizers. In some cases, taxes on liquid fuels and motor vehicles have been used, which have been redesigned to incorporate the damage that their consumption and use generate in the environment. Despite evidence of the positive effects of the environmental taxes their use is very limited in most countries. This is the case in LAC, where there are numerous taxes levied on

² Alejos, L (2017). Estimating the impact of extreme weather events. Working Paper.

³ Almeida, M. y Torres, A. (Forthcoming 2020). Propuesta de implementación de un sistema de marcación del gasto público climático y en biodiversidad.

environmentally basis, but which are designed exclusively for tax collection purposes. However, there are some experiences from Chile, Mexico, Ecuador, and Colombia, that merit to be explored provide lessons that could be used to technically support better environmental tax designs and reforms.

- **Incorporating climate change criteria in public procurement policies and systems**, in accordance with international best practices. Green Public Procurement (GPP) is a process whereby public authorities seek to procure goods, services and works with reduced environmental impact throughout their lifecycle. While much has been done in this area in LAC, the information and lessons learned have not been systematized. Therefore, there is a need to address the gap on research that aims at exploring the challenges, lessons learned and opportunities in the area of green public procurement in the region.

- 2.6 **Main investigation gaps to be closed:** Currently, LAC countries need to adopt new methodologies and tools to: (i) Measure the impact of extreme natural events on fiscal sustainability; (ii) Account and evaluate public expenditures on climate change issues; (iii) Incorporate resiliency considerations on public investment management; (iv) Promote the use of environmental taxes in the region; and (v) Establish green procurement and acquisition policies. Since, these instruments and methodologies will be first of its kind in most LAC countries, the project will have a high degree of innovation in terms of incorporating climate change action on fiscal management and policies.
- 2.7 **Strategic Alignment** This TC is aligned with the IDB's Update to the Institutional Strategy 2020-2024 (AB-3190-2), in particular with the areas of: (i) Institutional Capacity and Rule of Law, by strengthening the capacity of government institutions in terms of fiscal management; (ii) Environmental Sustainability and Climate Change by mainstreaming mitigation and adaptation issues into fiscal policies and public financial management; and by incorporating the potential impacts of natural disasters on fiscal sustainability, and by promoting public investment management of sustainable infrastructure. Complementarily, the TC is aligned with the Corporate Results Framework 2020-2023 (GN-2831-8) concerning strengthening the IDB's operational work on the cross-cutting themes in climate change and environmental sustainability, as well as institutional capacity. Specifically, the TC aims to support beneficiary countries in the: (i) Reduction of greenhouse emissions; (ii) Strengthening tax and expenditure policies; (iii) Promoting sustainable investments; (iv) Enhancing disaster and climate change resilience; (v) Fiscal management of economic losses from natural disasters, and (vi) Improving the government effectiveness and strengthening capacities. Finally, the TC is aligned with the Ordinary Capital Strategic Development Program (GN-2819-1), that supports research and knowledge generation in priority Bank's areas such as climate change and fiscal policies.
- 2.8 The TC is also consistent with the beneficiary countries' development challenges and government priorities as stated in their respective Country Strategy⁴. All beneficiary countries have a pledge to climate change and committed to implement their NDCs. The beneficiary countries also coincide on key strategic areas as part of their sustainable development agenda such as: (i) Foster fiscal sustainability and public expenditure efficiency; (ii) Improve disaster risk management and adapt to climate

⁴ Country Strategy of Barbados (GN-2953-1), Brazil (GN-2973), Chile (GN-2946), Colombia (GN-2972), Costa Rica (GN-2977), Ecuador (GN-2924), and Guatemala (GN-2899).

change; (iii) Promote resilient infrastructure; (iv) Enhance environmental sustainability and climate change action; and (v) Improve public management effectiveness. The TC includes activities conducive to support the strategic areas of intervention.

- 2.9 This TC is also aligned with the Fiscal Policy Framework (GN-2831-3) that promotes fiscal policy management to foster more proactive, stable, sustainable, and equitable growth⁵. It is also aligned with the Climate Change Sector Framework document (GN-2835-5), particularly with the dimensions of supporting countries to have: (i) institutions that support objectives and commitments toward climate-resilient and low-carbon development; (ii) access to climate finance and effectiveness of its use; (iii) knowledge to effectively support a just transition toward a climate-resilient and low-carbon economy; and (iv) progress on mainstreaming climate considerations across sectors. The TC is aligned with the Ordinary Capital Strategic Development Programs (GN-2819-1) which supports initiatives aimed at addressing climate change adaptation and mitigation, and environmental sustainability; and strengthening institutions and policies, particularly fiscal policy and management. The TC is also aligned with the NDC Pipeline Accelerator given that the program aims at improving the countries' fiscal policies and climate change strategies (including NDCs), long term decarbonization goals, and mitigation and adaptation plans. The TC, through the project activities will support the implementation of the Bahamas Resolution Mandate to increase the IDB climate finance to 30% for 2020.
- 2.10 This TC will coordinate with other on-going projects that support the design, implementation and financing of NDCs such as: "Financing the Design and implementation of Nationally Determined Contributions" (ATN/MC-17416-RG) and "Financing Implementation of Intended Nationally Determined Contributions" (ATN/MC-15367-RG). The proposed TC will focus on the development of technical capacities for better fiscal policies related with climate change and track progress in the implementation of sustainable public spending related to NDCs. The program will also improve the efficiency of public spending on climate change through enhancements of the fiscal and budgetary framework, adopt a new methodology to track and report climate-related public expenditures, establish a regional tracking system to account and report public spending on climate change, and support capacity building of national entities.

3. Description of activities/components and budget

- 3.1 To achieve the objectives set, this TC will develop the following activities organized into three components:
- 3.2 **Component I: Standardized instruments and methodologies (USD330,000):** This component will finance the preparation of guidelines and methodologies, which will be validated in potential beneficiary countries. It includes the following areas:
- (i) Guidelines and methodologies to measure the impact of extreme natural events on fiscal sustainability, including the development of models for estimating the fiscal impacts of natural disasters; integration of fiscal impact variables of CC in

⁵ The following four dimensions will guide the SFD's activities: (i) promote fiscal sustainability and macroeconomic stability; (ii) build institutional capacities to design and implement fiscal policies that improve efficient mobilization and allocation of resources; (iii) adopt fiscal policies that improve equity and social inclusion, consistent with the efficient allocation of resources; and (iv) strengthen the efficiency of tax administrations, financial management and use of public resources, and fiscal risk management.

the medium-term fiscal framework (MTFF) and medium-term expenditure framework (MTEF); and evaluation of the CC's fiscal risk management.

- (ii) Operational manual to identify/tag and evaluate public expenditures on climate change including the establishment of specific norms of public financial management, a set of indicators, and evaluation metrics of efficiency and effectiveness of spending on mitigation and adaptation.
 - (iii) Operational manual to support ex-ante evaluation and improve the selection process of sustainable public investments and services. This includes, amongst others, guidelines to integrate CC parameters in the assessment and programming of public investment (e.g. climate vulnerability metrics; carbon price shadows); integrate sustainability indicators in the public investment management systems; and propose financing strategies for multi-year investment programs.
 - (iv) An action plan for the design and implementation of environmental taxes in the region. This will include consolidation of experiences, lessons learned and best international and regional practices in green taxes (congestion taxes, vehicle taxes, urban and rural property taxes), and guidelines for the design and implementation of environmental taxes in the region, ensuring a balance between the tax collection purposes and environmental externalities.
 - (v) An action plan to foster green procurement and acquisition policies. This will include consolidation of international experiences, lessons learned and best practices in green procurement and acquisition, and the design of an action plan to facilitate the adoption of green procurement in LAC countries.
- 3.3 Through the development of these standardized guidelines and methodologies, , the project will contribute to streamline climate change action into fiscal policies, achieve a better integration of fiscal impact variables of CC in the medium-term fiscal framework, improve the quality and transparency of CC related expenditures, enhance the design of environmental taxes, and improve knowledge of carbon financing. By adopting new developed methodologies and instruments, the Ministries of Finance will build their institutional capacity to systematically include CC within their fiscal policies and management systems. The expected result of this component is that at least five beneficiary countries will adopt the products developed in this component.
- 3.4 **Component II: Operational support (USD170,000).** The component will provide know how and technical support to the Ministries of Finance aimed at: (i) screening opportunities to include climate change actions within fiscal policies and management systems; with special emphasis on public expenditures (both current and capital expenditures) and transparency; and (ii) designing and streamlining specific climate change activities financed through IDB's operations using the previously developed instruments and methodologies described in Component 1. As a result of these activities, the Ministries of Finance will be better equipped to incorporate specific climate change actions within their fiscal policies and financial management systems.
- 3.5 **Component III: Strengthening institutional capacity (USD120,000):** Dissemination of the instruments and methodologies developed in Component 1 through: (i) Two practical workshops; and (ii) Publication of two technical notes. Additionally, the component will finance the implementation of three academic forums to present new research papers in the area of fiscal policy and climate change. As a result of these

activities, the beneficiary countries will increase their technical capacities in terms of climate change and fiscal policies.

- 3.6 **Budget.** The total amount of funding needed is USD 620,000. INS (Strategic Program for the Development of Institutions; US\$250,000); ACL (Accelerator Multi-donor Trust Fund; US\$250,000), SUS (OC Strategic Development Program for Sustainability; US\$120,000).

Indicative Budget US\$

Activity/Component	Description	ACL	INS	SUS	Counterpart Funding	Total Funding
Component 1	Standardized instruments and methodologies	250,000	80,000		-	330,000
Component 2	Operational support		170,000		-	170,000
Component 3	Strengthening institutional capacity			120,000	-	120,000
Total		250,000	250,000	120,000		620,000

- 3.7 The evaluation framework to track the progress of the TC against its expected outcomes and outputs, and indicators is included in Annex I (Results Matrix). The expected outputs of the TC will strengthen fiscal policies and public management systems.

4. Executing agency and execution structure

- 4.1 Given the regional dimension, the taxonomy of this TC (research and dissemination) and the lack of a regional entity with capacity to implement it, the Bank will be the executing agency through the Fiscal Management Division (IFD/FMM) in coordination with the Climate Change Division (CSD/CCS) and the Country Offices (COF) of the beneficiary countries as needed. The substantial experience of the Bank developing new operational products will ensure the sustainability of this TC implementation. The countries will participate through their Ministries of Finance, Planning, and/or Environmental and Natural Resources (when required), and formal protocols to inform national authorities will be followed prior to execution.
- 4.2 The operation will be supervised by the team leader with the support of the operations analyst and the fiscal division specialists in the COF. The team leader will be responsible for the monitoring and evaluation of the objectives and indicators of this TC, as well as its financial execution in accordance with the annual operations plan. Fiduciary supervision will be carried out by the fiduciary specialist assigned to the TC. This TC will be monitored and evaluated following the Bank's established processes and criteria and in accordance with its results matrix.
- 4.3 The Bank will coordinate the activities for the TC through Ministries of Finance. The activities to be executed under this operation have been included in the Procurement Plan (Annex III) and will be executed in accordance with the policies and procedures established by the Bank: (i) individual consultants, as established in the document AM-650 - Complementary Workforce; (ii) consulting firms for services of an intellectual nature according to the Policy for the Selection and Contracting of Consulting Firms in Bank executed Operational Work (GN-2765-4) and its associated operational guides

(OP-1155-4); and (iii) logistic services and other services other than consulting, according to the Corporate Procurement Policy (GN-2303-28).

5. Major issues

- 5.1 The main risks associated with this TC is the lack of institutional capacities and limited information related to climate change issues in the participating countries. To mitigate these risks, the TC incorporates Component III (Strengthening the institutional capacity) to improve information systems and capacity building of institutional counterparts in fiscal policy and climate change affairs. The innovative nature of this TC could also be a risk. To mitigate this risk, the TC will support pilots for the application of the methodologies and /or guidelines developed to ensure these meet their purposes and can be successfully operated.
- 5.2 To contribute to the sustainability of the products financed by this TC among beneficiary public institutions, the project will support the adaptation and implementation of the operational guidelines within the existing public management systems. At the same time, the project will include an active participation of public officials in the execution of the activities and products of the TC, ensuring the appropriation of the new methodologies and tools by the Ministries of Finance.
- 5.3 To ensure the adequate execution of the TC under COVID-19 the project team and consultants will adopt the regulations of each country, respect quarantines, and work with adequate tools and protocols to ensure health issues while completing all the planned project activities.

6. Exceptions to Bank policy

- 6.1 There are no exceptions to Bank policy considered.

7. Environmental and Social Strategy

- 7.1 Due to their nature, the activities in this TC will not have negative social or environmental impacts. This TC is classified as "C".

Required Annexes:

[Results Matrix_44702.pdf](#)

[Procurement Plan_1701.pdf](#)