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STRENGTHENING THE ROLE OF MINISTRIES OF FINANCE IN DRIVING CLIMATE ACTION

This is Third Generation Environmentalism (E3G)'s response to the consultation from The Coalition of Finance Ministers for Climate Action on strengthening the role of ministries of finance in driving climate action closing on 3rd February 2023.

Summary

Managing the net zero transition and increasing resilience requires significant changes in the way we structure and manage key economic activities. Some of the key tools to do so are under the purview of the ministries of finance as they are shapers of the national economies, the global financial architecture, macroeconomic norms and regulation. Their response to the economic risks of climate change has implications for the wider economy.

Furthermore, the mandate of the ministries of finance **broadly speaking is: "to protect public finances and ensure the nation's prosperity"**.[1] Climate is in many ways included in the broader mandate, in the sense of protecting prosperity.

E3G welcomes the framework proposed by the Coalition, and the two-pronged approach that explicitly refers to finance ministries' core functions and capabilities. To ensure this framework informs how best to strengthen the role of the ministries of finance, E3G suggests:

> Emphasise the role of networks that the ministries are part of, such as MDBs, IMF, OECD, G20, G7, IPSF, FSB, NGFS. Ministries can access expertise through these networks to build their own capacities, while ensuring that other members also develop the thinking and capacities they might require as the transition unfolds.

> Design a self-diagnostic process, broken down across the different functions of ministers of finance. E3G has proposed some questions as a starting point

[1] E3G, 2021, **The centrality of ministers of finance in a changing climate**

to help kick start the process and inform different policies such as taxation policy. For example, understanding the share of the existing tax base that is exposed to the transition will help to anticipate shifts in the tax base and identify offsetting revenue sources.

> Create an implementation process for how finance ministries can deliver the required actions suggested in the report by providing a step-by-step approach. This is in recognition that ministries have yet to build the capacity and most of the necessary capabilities to take forward the suggested actions at the national level that will be necessary to effect this change.

> The Coalition is well-positioned to help facilitate learning and share best practice across their network, and act as an intermediary between various ministries of finance and international finance institutions. Consider establishing a learning hub within the coalition.

Consultation response

Question 1. Role What role should Ministries of Finance play in driving climate action? Are their mandates and roles sufficiently well-defined?

As decarbonisation deepens and spreads to encompass the whole economy, and as the need to build resilience against unavoidable climate impacts rises, more and more of the critical decisions on the pace and scale of climate action are primarily made at the economy-wide level rather than as part of sectoral policy in the energy, transport, and agricultural sectors. This requires significant changes in the way we structure and manage key economic activities. Treating climate as sitting within an environmental silo or as an additional budget line understates the required nature and scale of action.

Many of the tools needed to manage the transition and ensure economic stability are under the purview of the ministries of finance, from regulation and planning to funding, taxes and subsidies. The ministries will also be at the core of the political economy debate at the macro level around critical questions: Who should pay, and who benefits? Who has the economic power? And how can policies support the collective prosperity of the nation?[2]

As the threat of non-financial shocks grows – with climate change a key driver – finance ministries will increasingly have to assess, plan for, and respond to such

[2] E3G, 2021, **The centrality of ministers of finance in a changing climate**

shocks. For example, in the case of climate change, fiscal policy, economic planning and financial sector regulation can all affect future emissions and a nation's resilience to climate-related impact. This means that the economic risks of climate change, both physical and transition-related, are to some extent endogenous, and how ministries of finance respond to these risks could generate wider feedback loops.[3]

Ministers of finance and those who are responsible for governments' central finance functions are central to both current and future crisis responses. As well as shaping the national economy and frequently setting the boundaries for what other ministries and domiciled financial firms can do, finance ministries are influential in shaping the global financial architecture, macroeconomic norms and regulation through their positions within the networks of global economic leadership, including as shareholders of the IMF and MDBs.

The mandate of finance ministries has yet to be defined in the report. E3G suggests introducing a definition, as this could provide the basis to understand whether and how the mandate might need to evolve.

In a previous report, **E3G defined the mandate of finance ministries broadly speaking as: "to protect public finance and ensure the nation's prosperity"**.[4] In general however, interpretations of the mandate and purview have been conservative and focussed on economic and fiscal questions, and have struggled to evolve to consider new challenges. This is especially true when the consensus on economic management – and the primacy of not disrupting markets – makes it difficult for finance ministries to challenge the status quo and make system-wide changes, for example, setting a new direction for the financial sector.[5] Nonetheless, climate is in many ways included in the broader mandate, in the sense of protecting prosperity.

[3] E3G, 2021, **The centrality of ministers of finance in a changing climate**

[4] E3G, 2021, **The centrality of ministers of finance in a changing climate**

[5] E3G, 2021, **The centrality of ministers of finance in a changing climate**

Question 2. Framework How do you view the usefulness of the proposed framework? What additional evidence should be considered?

E3G welcomes the framework, and the two-pronged approach that explicitly refers to the core functions and capabilities of the ministries of finance.

E3G suggests also emphasising the role of networks that the ministries are part of, such as the MDBs, IMF, OECD, G20, G7, IPSF, FSB, NGFS, Coalition of Finance Ministers for Climate Action and regional groups. Doing so could provide venues for ministries to access expertise to leverage their own capacities, while ensuring that those networks are developing the thinking and capacities that their members might require as the transition unfolds, and which can lead to the enhancement of international norms to reflect the challenges created by climate change.

E3G suggests a more nuanced approach in table 1.I in the report, encouraging a self-diagnosis of which areas will need to be updated/adjusted rather than listing major functions that need to be green. What table 1.I calls opportunities to mainstream climate action could be renamed as “examples of potential outputs from the diagnostic process”.

Some ministries of finance and the G20 have explicitly called for more work to understand the macroeconomic costs and benefits as well as the distributional impacts of climate action.[6] The presence of finance ministries within, and with influence over, powerful institutions and networks has yet to be fully utilised.

E3G has already identified some of the questions for a self-diagnostic process, broken down across the different functions of ministers of finance[7].

> **Taxation:** Has an understanding of the share of the existing tax base that is exposed to the transition been developed in order to anticipate shifts in the tax base and identify offsetting revenue sources? There also needs to be a discussion with the relevant line ministries to understand what accompanying measures could encourage the adoption of different technologies, such as new transport modes.

> **Debt management:** As bond buyers increasingly consider climate change in their investment assessment, are all available tools being utilised to assess climate exposure in order to manage future debt profiles?

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[6] European Council, 2021, **G20 Rome Leaders’ Declaration**

[7] E3G, 2021, **The centrality of ministers of finance in a changing climate**

- **Budget management:** Are climate mitigation and adaptation measures being integrated into long-term budgeting as an investment that will yield cashflow rather than a cost? Is correct budget allocation being used to deliver the transition successfully? How best to capture in the budget the potential spillovers that addressing climate might have?
- **Public investment:** For all publicly funded infrastructure and capital stocks, has an assessment of the resilience to these investments been undertaken?[8] Has the long-term strategy or pathway for decarbonisation, combined with national development plans, been fed into the improved design of processes for public investment?
- **Fiscal policy formulation:** Has fiscal policy been based on a range of macroeconomic scenarios that capture the impact of a range of risks including climate impacts? One approach would be to identify potential climate impacts and how likely they are to take place. Once the risks and probabilities have been identified, their potential impact on different areas of government revenues and spending should be quantified based on analysis of public accounts.
- **Setting parameters for the financial sector:** What are the key roles that the ministry wishes the financial sector to play in the national economy? (For example: financing the national transition, building a competitive green finance centre and exporting services to other countries, stewardship of real economy firms to support the transition and manage climate risks). Are processes in place at national level to track progress towards these goals, for example to monitor green financial flows? Are enabling conditions and regulations sufficient to drive the required behaviour change in the financial sector?
- **Networks and coalitions:** Is there ongoing engagement and collaboration with other line ministries, particularly ministries of environment, on long-term strategies? Is the know-how and financial support from a wider range of partners, including international institutions, being leveraged?

We propose referencing the powerful political position that ministries of finance hold, as well as some of the political constraints they face – their agenda will be influenced by both the political and institutional leadership.

[8] For example, a finance minister might instruct a national sovereign wealth fund to undertake comprehensive climate risk assessments.

Question 3. Actions What steps in the 15 action areas and beyond outlined in Part C of this report are the most critical to achieving progress? Are there any missing?

The action areas cover a good range of options for the ministers of finance to take forward.

E3G suggests creating an implementation process for how finance ministries can deliver the required actions. This in recognition that ministries have yet to build the capacity and most of the necessary capabilities to take forward the suggested actions.

As a starting point, E3G suggests ministries take the following step-wise approach.

> Seek to understand how the transition and climate change impacts might affect the sectors of the economy.

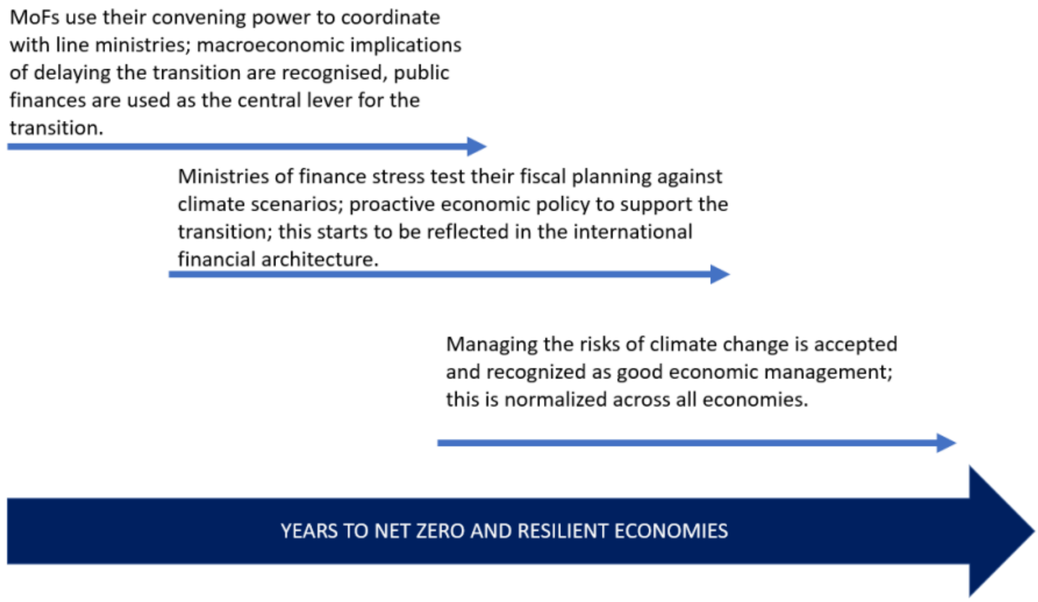
> Request modelling of the different transition pathways based on crucial development targets already pre-established, such as employment by sector, government revenues, etc.

> Consider convening other ministries and financial regulators – where there is insufficient inter-agency collaboration – to determine the level of understanding and work done around the impacts of the transition.

> Consider approaching local academia and civil society to open a consultation on some of the findings from the process.

> (If capacity for such analysis isn't available within the ministry) approach a third party to provide the initial work in close coordination while the capacity is developed.

The following figure suggests how finance ministries' response to climate change should evolve over the longer term.



From the steps in the 15 action areas identified in the report, E3G suggests merging the following action areas as they are closely related:

> #1 & 11: "Developing clear Ministry-wide strategies and working with Heads of State to enhance their mandates for climate action"; "Integrating climate action into national growth and development strategies."

> #2 – 4: "Reforming internal institutional arrangements to ensure dedicated capacity for climate action"; "Actively participate in inter-agency and stakeholder coordination and ensuring a whole-of-government approach to climate policy"; "Investing in new skills and expertise to drive climate action."

> #6 – 8: "Actively using the full suite of fiscal policy measures to transform macroeconomic incentives for climate action"; "Reviewing and redesigning the overall tax system for net zero and climate resilience"; "Paying particular attention to active use of the annual budget process and medium-term expenditure frameworks to drive transformation of all sectors of the economy."

> #12 & 13: "Supporting line ministries to develop fully costed national climate strategies"; "Developing sustainable, inclusive and resilient transition and investment strategies."

E3G has ranked the most important actions following the current draft of the report:

> *#6 Actively using the full suite of fiscal policy measures to transform macroeconomic incentives for climate action*

> *#11 Integrating climate action into national growth and development strategies.*

> *#12 Supporting line ministries to develop fully costed national climate strategies*

> *#13 Developing sustainable, inclusive and resilient transition and investment strategies*

> *#10 Leveraging international climate finance and encouraging the strengthening of the global financial architecture, working with Foreign Ministries and development agencies.*

Question 4. Capabilities Which organizational reforms are most important for strengthening the capability of Ministries of Finance to act on climate? How should Ministries of Finance prioritize their efforts?

Safeguarding economic development will require coordination between finance ministries, line ministries, financial regulators and central banks. Sectoral experts within line ministries will be key in identifying and selecting projects for public funding and therefore reducing exposure to potential stranded assets and increasing resilience. Given the cross-cutting nature of climate change, stronger collaboration between line ministries, directed by finance ministries, would be necessary. This is essential as decisions at the sectoral level have implications for public finances, while finance ministries will also need to better understand the sensitivity of different areas of the economy to climate impacts.[9]

To gain that understanding, there must be a strategy that delineates the decarbonisation process at a sectoral level, which can then inform the scale of finance needed and the balance between public and private sector participation. This will also facilitate the identification of changes to the regulatory framework and new regulations required. All this needs to take into consideration individual countries' circumstances, which tends to be overlooked. Finance ministries should encourage the step-by-step development of long-term decarbonisation

[9] E3G (2021) **The Centrality of Ministers of Finance in a Changing Climate**

strategies which can capture the evolution of the national economy, as well as the trade-offs and the low-hanging fruit through the transition.[10]

Question 5. Challenges What are the key challenges that hold back progress by Ministries of Finance? How can these be overcome?

The points below are taken from the report*:* D. Orozco, M. Jaramillo, 2021, "The centrality of ministers of finance in a changing climate" (E3G).

The challenges that prevent finance ministries from taking more decisive action on climate change can be grouped into four broad categories:

i. Constrained economic and financial thinking – The successes of the market-based economy has led to a great reluctance to challenge market outcomes, even when these are distorted. A related issue is problematic tail risks: many of the impacts of climate change are not linear, but instead represent increased probabilities of high impact disasters. The economic models that provide input for policy decisions are not adequate for risks like climate change.

ii. Aversion to active economic planning – Even where the imperative for supporting an orderly transition is recognised, finance ministries are reluctant to deviate from their traditional toolkits. Developed over the past forty years, these are principally focussed on market signals – communicated via prices – in the near term. More active economic management, i.e., more hands-on fiscal policy, seems to be outside most finance ministries' current focus and toolkit (and indeed the electoral cycle).

iii. Complexity of a cross-cutting challenge – Climate will impact all areas of government, which hampers decisive action from any one ministry, and adds a level of complexity that the government isn't used to handling.

iv. Lack of capacity – Finance ministry staff may lack knowledge of climate issues and their impacts. This is part of a vicious circle where a lack of knowledge means that the case for recruiting specialists is not understood. This dynamic is only enhanced by the conservative nature of many finance ministries.

Some of the challenges are not intrinsically unique to the ministers of finance. Below there are some proposals on how best to overcome the challenges.

[10] E3G, 2021, **The centrality of ministers of finance in a changing climate**

i. To overcome constrained economic thinking and the aversion to economic planning – Start by recognising that future risks will be increasingly non-linear, whereas the current economic risk management is grounded in linear thinking.[11] The tools that finance ministries use to assess risk may be misleading them, with an overreliance on policy-making based on a single scenario or forecast that is treated as if it were infallible. This gap must be addressed to ensure that the appropriate fiscal policy is in place to achieve the transition.

The ministries of finance might need to prepare to have more open debates with civil society and the financial sector and to create a space for forward thinking. Where possible they should diversify their own staff, including those working on financial sector regulation, engaging experts in climate and other areas relevant to the country.

ii. To overcome the complexity of dealing with cross-cutting issue – E3G recommends that ministries of finance use their convening power to bring relevant line ministries to the table if the conversation on climate change has not yet started at the country level. In other cases, finance ministries should (co-)direct a strong collaboration between line ministries. Finance ministries have the necessary convening power to ensure alignment between ministries and that sectoral strategies interlock to deliver both decarbonisation and economic growth.

iii. To overcome the lack of capacity – E3G recommends that finance ministries leverage the know-how and financial support from a broader range of partners, including the international institutions in which they are shareholders, and the network they belong to. For example, some of the key institutions – IMF, OECD, MDBs – which provide economic advice and set the best practices that are widely adopted by finance ministries.

Question 6. Implementation What key actions can the Coalition of Finance Ministers for Climate Action take to most effectively support its members to deliver on the agenda proposed in this guide?

> As a network, the Coalition can help facilitate learning and share best practice across the network. However, it is important that consultations and wider participation of civil society are encouraged.

[11] COVID showed the limits of finance ministries' traditional playbook: it was not a traditional financial or economic crisis, and previous experiences were of limited use.

> Engage academics and civil society to help grow the community around ministers of finance, allowing them to tap into the research and thinking underway on how to drive climate action.

> Lead on communications with civil society, business, and other stakeholders to promote the ambitions of the Coalition. Greater engagement can encourage buy-in and collaboration with these stakeholders to drive climate action further.

> The coalition is well-positioned to act as an intermediary between various finance ministries and international financial institutions.

> E3G suggests creating an implementation process for how finance ministries can deliver the required actions. This in recognition that ministries have yet to build the capacity and most of the necessary capabilities to take forward the suggested actions. Suggestions are outlined in question 2.

Question 7. Report/Evidence Do you have any suggestions for strengthening the report? What additional evidence should be considered?

E3G proposes that:

> The explicit link between climate and development be brought out more. Climate change poses a significant threat to poverty reduction in many regions, while the energy transition brings both opportunities and threats to economic growth.[12]

> Including a self-diagnosing process – as stated in our response to question 2 – could support ministries of finance to empower their staff. This could be the starting point of a potential learning hub hosted by the Coalition.

> When defining the functions of finance ministries, the report states that responsibility for regulating the financial sector is shared with other departments and institutions. E3G suggests emphasising that finance ministers do still have overall responsibility and control. In many cases finance ministries give mandates to central banks and financial regulators, essentially delegating how the financial sector is managed. This could be stated more explicitly in function #3.

> E3G suggest including an additional action point - Call on finance ministers to drive an integrated and strategic approach to all national shareholders in IFIs to ensure their effectiveness in meeting the climate challenge

[12] E3G, 2021, **The centrality of ministers of finance in a changing climate**

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Question 8. Other Do you have any additional feedback?

> E3G recommends that the report be made more concise. There is a wealth of useful information, though perhaps a lot to sieve through, which risks the main messages becoming overshadowed.

> An infographic may help readers engage with the report by making it more easily digestible. This could increase understanding of the key messages of the report and the proposed framework.

About E3G

E3G is an independent climate change think tank with a global outlook. We work on the frontier of the climate landscape, tackling the barriers and advancing the solutions to a safe climate. Our goal is to translate climate politics, economics and policies into action.

E3G builds broad-based coalitions to deliver a safe climate, working closely with like-minded partners in government, politics, civil society, science, the media, public interest foundations and elsewhere to leverage change.

More information is available at **www.e3g.org**