

Adapting Fiscal Decentralization Design to Combat Climate Change

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Overview

- This review paper: (i) examines the re-design of the basic principles of fiscal decentralization from the perspective of fighting climate change; and (ii) reviews the international practices for engaging (SNGs) in fighting climate change and identify best practices
- Some international good practices are available for how to engage subnational governments.
- However, overall, still many countries around the world still have to effectively engaged their SNGs in their overall climate change policy frameworks.

Sizing the potential role of subnational governments in decarbonization and adaptation policies

- From the main sources of GHG emissions identified in the Stern (2007) report, up to 40 percent may come from activities (transport, housing etc.) over which subnational governments typically exert regulatory and taxing powers → SNGs have a big potential role to play in climate change.
- The role of subnational governments becomes potentially stronger in terms of adaptation policies (given the smaller importance here of externalities).
- But that involvement has some natural limits. SNGs can better cater to differences in needs, provide a laboratory setting for testing effectiveness, etc. Big disadvantages are lower effectiveness in dealing with externalities (and economies of scale)...and others (like lower capacity, predatory policies, etc.)

Measuring actual SNGs involvement difficult with the information available

- One approach is to look at the share of environmental expenditures of SNGs in each country (But ignores other decarbonization activities like in transportation or sanitization, or expenditures in adaptation projects). Overall, this type of measure provides very low numbers with respect to GDP in rich and poor countries.)
- An alternative measure, SNGs involvement in the Nationally Determined Contributions (NDCs) under the Paris Agreement, also yield so far modest indicators.

On the practice of expenditure assignments for more effective action on climate change

- On balance, a model with shared responsibilities between central and subnational authorities allowing subnational units to exceed national targets could be a preferred approach:
 - Central authorities can design national programs and coordination.
 - SNGs can experiment and innovation, as well as better needs matching and accountability.
 - SNGs can compete in “a race to the top,”
 - National coordination looks after externalities and avoids “race to the bottom” situations
- A centralized approach, fails to take advantage of innovation and experimentation at the subnational level, etc.
- A highly decentralized approach, with much less coordination and with sometimes SNGs playing a leadership role risks not addressing externalities or experiencing a “race to the bottom” among SNGs.
- With concurrent responsibilities, clarity is needed in who is responsible for the different attributes of each function (regulation, financing and actual implementation). It also requires effective intergovernmental coordination and cooperation.

Improving the assignment of revenue and tax authority for enhancing action on climate change (1)

- Constraints:
 - mobility of business and households;
 - benefits of climate change action are in many cases not localized (benefit principle fails)
 - SNGs in many countries are in fact devolved very low levels of taxation authority.
- Other factors may contribute to the low powers of SNG green taxation:
 - Perception of regressive incidence;
 - Technical/administrative issues: Some green taxes complex to administer; lower ability to measure and monitor pollution emissions.
- From the theory of revenue assignments: If the externality is confined to a local area, the responsibility for the proper green tax should be local. As the area of the externality increases to the regional or national level, then the proper assignment of tax powers should be regional or national.
- The appeal of (SNG) green taxes is that they yield a double dividend: decarbonization and increased budget revenues....Better local services may offset incentives to out-migrate because of the green taxes.

Improving the assignment of revenue and tax authority for enhancing action on climate change (2)

- In the case of adaptation activities, which are more localized, more room for the benefit principle: fees and charges, real estate property taxes, betterment levies and other land value capture measures (many adaptation activities will result in land value increments).
- In practice, very low levels of green taxation in most countries around the world. This fiscal space is even much larger at the SNG level because of the large vertical fiscal imbalances most decentralized countries experience.
- Review of country practices with green subnational levies uncovers a collection of different green tax instruments, in a little more than a handful of decentralized countries.
- Many other decentralized countries so far have not introduced subnational green taxation –other than the usual charges for waste collection, etc...so ample room exists for replication.

Redesign and innovations in transfer systems to combat climate change

- Transfers are likely the most suitable versatile financing instrument for internalizing spatial externalities related to decarbonization and adaptation programs. Beyond conventional conditional grants, CGs also use different types of subsidies and direct performance contracts and agreements with SNGs.
- Conditional grants, for recurrent and capital purposes and with ex-ante or ex-post conditionality are generally well equipped for designing and implementing climate specific transfers to SNGs. Conditional transfers can be used to compensate local jurisdictions for internalizing different types of externalities, incentivize different conservation activities, promote energy efficiency, or introduce land-use restrictions to prevent flooding damages.
- These transfers generally should be designed separately from transfers already pursuing other objectives (equalization, etc.)
- Examples: Conditional grants are being used for forest conservation programs, as in the case of Brazil states' ecological "ICMS" or Portugal's ecological fiscal transfer for land conservation. In other countries, like Australia and the United Kingdom, higher-level governments are entering into agreements and contracts with local governments to undertake determined "climate services."

Adapting subnational borrowing and other fiscal rules to facilitate effective policies for climate change

- Prudential borrowing is a powerful financing complement for SNGs to invest in infrastructure projects for decarbonization and adaptation activities in combatting climate change (and general desirable from both efficiency and equity perspectives).
- Question is, whether SNGs' borrowing rules can be justifiably relaxed to further incentivize subnational spending in green projects?
- An innovation in this regard has been the introduction of “green bonds” (also known as climate bonds): They offer tax advantages, such as exemptions and credits, making them more attractive to investors, while still backed by the full faith and credit of the issuing government.
- An increasing number of countries are making use of “green bonds” by SNGs, but size of the sovereign green bond market is still small.

In Conclusion

- In theory, there is a lot to be done to redesign fiscal decentralization policies to better enable SNGs to combat climate change
- In practice, there is ample space for the further involvement of SNGs across the world in fighting climate change.

Thank You
