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Repairing the Past, Financing the Future

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Abstract : *Climate change disproportionately affects developing countries, with 15% of South Asia's GDP expected to be climate-compromised by 2050. Despite developed countries having historically contributed to three-fourths of carbon dioxide emissions, they are much less exposed to the consequences of climate change. Economic development driven by emissions-led growth now insulates developed countries from the consequences of climate change, leaving lower-income countries more vulnerable to the adverse effects the climate crisis poses. As the global economy contends with severe debt distress and increased climate risk that threatens long-term economic potential, the global financial system must empower developing countries to invest in climate-resilient infrastructure and prevent a 'climate debt trap.' This Policy Brief examines why accessible climate finance is essential to address converging debt and climate vulnerabilities in Sri Lanka, and identifies mechanisms to unlock concessional finance that will allow Sri Lanka and other developing countries to reallocate funds into climate-resilient infrastructure investments and climate change adaptation and mitigation measures.*

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Repairing the Past, Financing the Future

Why Climate Finance is Essential to Address Debt and Climate Vulnerabilities in Sri Lanka

Michael Iveson and Timothy Shankar*

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1. Introduction

The challenges of mounting debt and climate change have emerged as two of the most pressing issues for developing countries, and Sri Lanka is no exception. Climate and debt vulnerabilities are inherently connected and share a symbiotic relationship; the United Nations Conference on Trade and Development (UNCTAD) recommends that governments tackle these two challenges simultaneously through comprehensive solutions and climate-resilient structural transformation. The global economy currently faces serious debt distress and developing countries are pressed to find innovative solutions that address both climate and debt crises under the constraints of the current global financial architecture.

At the 2023 Summit for a New Global Financing Pact in Paris, which was held on the 22nd and 23rd of June, President Ranil Wickremesinghe called for a "separate, innovative process for middle-income countries" to address their debt challenges, and advocated for "timely and automatic access to concessional financing". The President also underscored the importance of prompt debt restructuring to ensure economic recovery, especially in the context of SriLanka's Climate Prosperity Plan, which concerns renewable energy, the conservation of biodiversity, and the sustainable development of climate-resilient infrastructure. Tackling these converging vulnerabilities remains two of the government's top priorities. Moreover, the President called for multilateral development banks and international financial institutions to discover better solutions for providing emergency financing for countries in debt distress, adding that macroeconomic reform is essential.

During the World Economic Forum's Annual Meeting of the New Champions, which took place from the 27th to 29th of June 2023, Sri Lanka's Foreign Minister, Ali Sabry, emphasised the importance of sustainable debt restructuring, particularly for developing countries, stating that "...because of the financial crisis, you can't put your funding into other most important areas such as education, climate change, sustainable energy, renewable energy because you aregrappling with your interest payments and your debt payments."

The President and Foreign Minister reaffirmed that solutions to Sri Lanka's economic crisis and the global debt crisis require a new approach. Developing countries face significant challenges to meet debt obligations and are foregoing essential investments in infrastructure for economic development. These opportunity costs emerge as developing countries are unable to pursue the same economic development strategies as their developed counterparts. If global climate priorities require developing countries to find innovative approaches to sustainable development, developed countries must provide essential finance to support this process and offset their historical contribution to climate change.

2. Climate Debt: The Mismatch Between Climate Change Contribution and Vulnerability

Climate change disproportionately affects the economies of developing countries, with 15% of South Asia's GDP expected to be at risk by 2050. Consequently, these nations are forced to spend more on recovery, adaptation and redevelopment loans. On average, these costs are more expensive for low-income, climate change-vulnerable nations as they are more severely affected by extreme weather events and their sovereign credit ratings are generally lower. Despite being responsible for 79% of total worldwide carbon emissions, developed countries stand to lose significantly less in climate-compromised GDP.

Figures 1 and 2 highlight this asymmetry; high-income countries face much less exposure to the consequences of climate change despite their historical contribution to emissions. Their economic development was driven by emissions-led growth and investments with negative externalities, yet it is this economic development that insulates them from the consequences of climate change that face developing countries.

Figure 1: The Contribution of Developed and Developing Countries to CO_2 Emissions

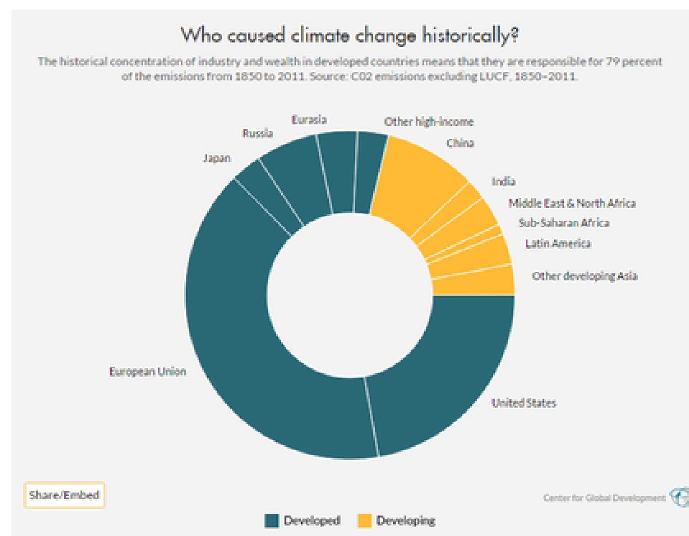
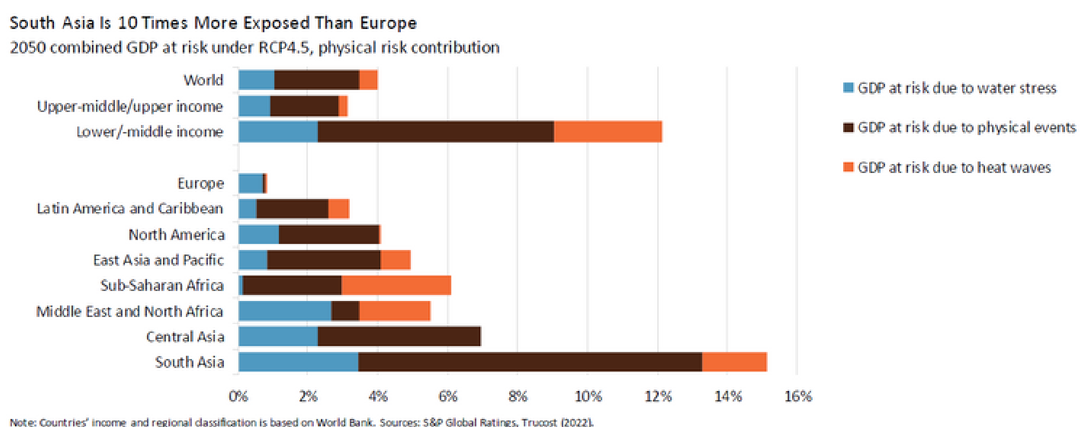


Figure 2: Risk of GDP Loss as a Result of Climate Change



Sri Lanka is categorised as ‘other developing Asia’ in Figure 1 and as ‘South Asia’ and ‘Lower/Middle Income’ in Figure 2. This highlights that Sri Lanka faces disproportionately high economic consequences of climate change relative to their historical contribution. Sri Lanka is vulnerable to the physical risks associated with climate change and these are forecasted to significantly dampen future GDP growth. The data shows that Sri Lanka has only accountedfor 0.03% of global cumulative emissions. Climate reparations for developing countries would ensure that Sri Lanka has access to essential financing to pursue climate-resilient investments and adaptation strategies that insulate them from the negative impacts of climate change.

Sri Lanka ranks 116th out of 182 on the GDP-adjusted climate vulnerability index, an indicator used to measure how vulnerable a country is to the direct impacts of climate change. The World Bank also projects that over 90% of Sri Lanka’s population currently live in locations that could become moderate to severe hotspots for droughts and floods by 2050, which makes the island extremely vulnerable to the direct consequences of climate change. Therefore, Sri Lanka must make strong commitments to climate-resilient investments and adaptation measures to mitigate future economic challenges. Sri Lanka’s updated Nationally Determined Contributions, which were submitted in 2021, commit to reducing their national greenhouse gas (GHG) emissions by 14.5%, transitioning to producing 70% of their national energy supply through renewable energy sources and increasing forest cover by 32% before the 2030 deadline. However, the government faces significant challenges in meeting these climate targets due to limited fiscal resources, low tax revenues and high levels of debt distress.

3. Financing Climate Action

Leading world economists and global policy experts have called for reform of the global financial architecture, proposing direct actions that developed countries must take to relieve debt and climate burdens on developing countries. They contend that climate finance instruments are essential for developing countries to address climate vulnerabilities in the face of mounting debt pressures and developed countries must make this finance accessible through revenue-generating solutions. There are currently very few financial incentives for creditors to make long-term climate finance accessible to developing countries as climate- resilient infrastructure does not generate short-term revenue. Financial institutions must recognise the non-revenue-generating benefits of such investments and make funding available for developing countries to invest in climate-resilient infrastructure without the pressure of servicing short-term debt repayments.

Given that developing countries are suffering disproportionately as a direct consequence of developed countries' historically unsustainable economic growth,

developed countries must provide financial support to countries facing severe climate risk. Funds for climate finance instruments and climate reparations must be made available through essential reforms to the global financial architecture, the fossil fuels industry, and global taxation mechanisms. These solutions would redistribute wealth to fund essential climate-resilient investments in developing countries and address debt and climate vulnerabilities simultaneously.

3.1 Reforming The Global Financial Architecture

Because of the fiscal constraints developing countries face in the ongoing global debt crisis, governments are unable to finance the necessary investments to mitigate the negative impacts of climate change. This creates a vicious cycle of debt and climate crises, where developing countries with high levels of debt are unable to mitigate climate risk, leaving them more vulnerable to the consequences of climate change. This increased climate risk exacerbates debt vulnerabilities by reducing the productive capacity of the economy. It is estimated that the 'climate debt trap' drains $2 trillion per year in resources from low-income countries and this will only increase as climate change pressures are exacerbated and debt financing is increased to deal with these. Since 2020, foreign debt repayments have risen by 45% and this places over half of all low-income countries in debt distress or high risk of debt distress. Experts have called for creditors to unconditionally cancel public external debt for lower- income countries for at least the next four years - estimated at around $300 billion a year - to free up funds from scheduled debt repayments.

Continuing to service unproductive external debt repayments redirects finance away from essential domestic investments for development and leads to capital flowing 'uphill' from developing countries to developed countries. This counters traditional economic theory, whereby capital should flow to regions where the marginal benefit of investment is greater: this is typically in developing countries where initial stock is low. The significant opportunity cost associated with debt repayments for developing countries also foregoes essential investments in climate-resilient infrastructure and climate change adaptation. Studies show that lower-income countries now spend over five times more on debt repayments than on national climate change adaptation, which demonstrates the constraints on public resources associated with unsustainable debt burdens.

The main challenge highlighted by international organisations is that the global financial system is structurally ineffective at addressing global debt crises. Enhancing financial solidarity between developed and developing economies requires the establishment of a new multilateral mechanism for sovereign debt forgiveness. There must be a transparent, binding framework in multilateral organisations that addresses

unsustainable debt structures in middle- and low-income countries that face debt and climate vulnerabilities. This should involve better access to concessional finance with policy autonomy, rather than imposing conditionalities and prolonging debt repayment periods. This would reduce the opportunity costs associated with long-term debt servicing periods and unlock the essential finance for climate-resilient investments and economic development.

3.2 Ending Subsidies in the Fossil Fuels Industry

Experts have urged governments to stop funding the fossil fuel industry and redirect this money towards climate finance projects for developing countries. On average, G20 governments provide $584 billion annually as fossil fuel handouts, such as through direct budgetary transfers and tax expenditure, price support, public finance, and investments into state-owned enterprises. The International Energy Agency established a scenario that forecasts a 50% chance to limit global heating to 1.5°C; however, this requires a rapid phase- out of fossil fuels and inhibiting investments in new fossil fuel production and liquified natural gas infrastructure.

They call for the G20 governments to end fossil fuel handouts immediately and reallocate this funding to a "Loss and Damage Fund", which is set to be activated at the 28th session of the Conference of Parties (COP) which is scheduled to take place at the end of 2023. "Loss and damage" refers to the consequences of man-made climate change such as rising sea levels, desertification and other extreme climate events. Countries that have used their share of the global carbon budget, like those comprising the G20, account for 75% of global greenhouse emissions and are generally more developed and less vulnerable to the effects of climate change. Through this fund, rich industrialised countries, whose economic growth was historically driven by fossil fuel-led industrialisation, will provide financial assistance to less- industrialised countries that are disproportionately more vulnerable to the impacts of climate change relative to their industrial contribution. Low-income countries' future growth is inhibited by climate challenges so these reparations aim to compensate for this loss of economic potential.

Despite major global players like Germany, Italy, Japan, and the United States signing the Glasgow "Statement on International Public Support for the Clean Energy Transition" which ends international public finance for fossil fuels, they have failed to uphold this commitment, providing $38 billion a year to fossil fuel companies. Without eliminating subsidies and placing pressure on the fossil fuel industry to diversify its portfolio, governments and international organisations risk enabling further climate damage through the continued unsustainable exploitation of finite natural resources. These funds must be reallocated to more environmentally sustainable industries, which will improve their competitiveness and fill the gap left by the phasing out of fossil fuels.

There is also a significant opportunity cost associated with such fossil fuel subsidies for developing countries. If the global financial system continues to allocate finance towards a highly profitable fossil-fuel sector, this is foregoing other essential investments that could be made for sustainable economic development. Developing countries like Sri Lanka require subsidies, grants, concessional finance, and unconditional aid transfers to invest in essential infrastructure and services that benefit citizens in these countries. This funding should be reallocated to these productive causes rather than financing industries that have contributed significantly to climate challenges that disproportionately affect developing countries.

3.3 Reforming Global Taxation Mechanisms

Tax revenue is a vital component of addressing climate change challenges in developing countries but also has broader implications for relieving fiscal constraints in other sectors of the economy. Because of the scale of the informal economy and typically weaker institutions in developing countries, tax revenue is a lot lower than the public expenditure required for development and this forces governments to take on debt to finance the gap. Debt is not necessarily a bad thing for developing countries when allocated to productive investments, but it does increase the dependence on the financial markets and developed bilateral creditors, which exacerbates vulnerabilities.

Oxfam reports that 63% of all new global capital created in the last two years (amounting to $42 trillion) went to the richest 1% of society, and for the first time in 25 years, extreme wealth and extreme poverty are rising simultaneously. This increase in global inequality undermines poverty alleviation efforts but also exacerbates climate inequality. The failure of taxation mechanisms to redistribute wealth and mobilise capital for development and climate change adaptation places further pressure on the financial resources of developing countries, which are diverging further and further away from their developed counterparts.

Economists posit that global wealth taxes are a simple and effective solution to redistributing funds to developing countries. They call for incremental changes on extreme wealth taxes beginning at 2%, which would generate substantial funds (estimated at $2.5 trillion a year, with higher rates generating around $3.6 trillion) for development and climate funds. Concerning taxation mechanisms, economists suggest that a robust and effective tax system is vital for the redistribution of wealth and sufficient finance to tackle the climate crisis. One policy recommendation is a "1.5% for 1.5°C" tax, which would impose a progressive taxation mechanism on the wealthiest 0.001% of the global population and raise an estimated $295 billion.

In its current form, the world's wealth tax mechanisms only contribute 4 cents on the dollar of global tax revenue. This is also reinforced by tax dodging, which must be eliminated as part of taxation reform. It is estimated that $483 billion in tax revenue is lost every year as a result of tax evasion, the majority of which comes through OECD countries. The Organisation for Economic Co-operation and Development (OECD) has acknowledged that current international tax rules are ineffective but meaningful reform has not yet taken place. Strong institutions and legislative frameworks must address these lost tax revenues and recognise the opportunity costs associated with tax dodging. One proposed solution to this is transferring the responsibility of tax regulation from the OECD to the United Nations, which would enable the creation of a universal and intergovernmental tax convention. Effective taxation is vital for reducing the overdependence on debt for financing development projects in developing countries and begins to address global inequality through the redistribution of wealth.

Furthermore, experts advocate for governments to make oil and gas companies pay for their damages. It is estimated that the share of emissions of the 21 largest fossil fuel companies from 1988-2022 will result in $5.444 trillion in lost GDP between 2025 and 2050. This also comes at a time when the 6 heaviest-polluting companies earned over $354 billion in profits in 2022. To privatise the costs associated with fossil fuel exploitation, economists also propose a "polluter pays" climate damages tax on fossil fuel companies, which could raise around $200-300 billion annually. This would exercise a windfall tax on the fossil fuels industry, which imposes an increased tax rate on unusually high corporation profits. This additional tax revenue would be allocated to productive instruments that offset fossil fuel-induced climate damages and mobilise further capital to directly mitigate the negative effects of climate change.

4. The Way Forward

Experts estimate that implementing the three aforementioned solutions would free up a total of $3.5 trillion annually for global climate action. Just one-fifth of this figure (approximately $600 billion) would be enough to finance the loss and damage fund ($400 billion per year), meet the $100 billion per year climate finance target, cover emergency UN humanitarian appeals ($52 billion per year), and close the universal energy gap ($34 billion per year). Implementing these solutions is undoubtedly difficult as it requires significant investment from developed countries to address climate vulnerabilities that are overrepresented in developing countries. Climate is a public good and developed countries must understand the wider benefits associated with empowering developing countries in the fight against climate change. Without access to concessional climate finance, developing countries will continue to suffer from the consequences of climate change without building resilience and adapting, which will exacerbate future climate problems that will also affect developed countries.

Sri Lanka, along with other developing countries, must intensify calls for concessional climate finance, shifting the onus of climate change mitigation onto developed countries that have had a historically greater contribution to rising global temperatures. Unlocking this finance would enable Sri Lanka to pursue its NDCs alongside its economic development goals. Developing countries must also increase the pressure on developed countries to further support sustainable economic development through climate adaptation and mitigation measures, which must minimise the disparity in climate change vulnerability between developed and developing nations. Without support from developed countries, developing countries will continue to suffer disproportionately from the consequences of global environmental degradation and this will further exacerbate global climate inequality.

Providing more generous conditions to debtor nations would unlock fiscal space for investments in climate-resilient infrastructure and essential public services. This would improve the productive capacity of the economy and mitigate the risks associated with climate change. Addressing climate and debt vulnerabilities simultaneously in Sri Lanka is vital and accessible climate finance must complement the ongoing debt restructuring processes. If Sri Lanka hopes to meet its ambitious environmental commitments in the face of debt distress, it requires a holistic approach from creditors and policymakers to reallocate finance to areas with the greatest economic potential. The government must explore climate finance instruments, such as green bonds, debt-for-nature and debt-for-climate swaps, alongside ongoing debt restructuring negotiations, as a means of creating a more sustainable debt environment and generating significant economic multiplier effects.

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