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IMF Executive Board Holds Seminar on the Fiscal Implications of Climate Change

On March 24, 2008, the Executive Board of the International Monetary Fund (IMF) held a seminar on the Fiscal Implications of Climate Change.[1]

Background

The seminar provided an opportunity for Directors to discuss the macroeconomic challenges posed by climate change and how the Fund might best help its members deal with them. The staff paper provided an overview of fiscal aspects. These, it argued, are critical in terms of both mitigation (actions to reduce emissions, and hence the extent of warming) and adaptation (reducing the damage from the warming that remains)—the former points to the potential value of ensuring emitters face an appropriate price for the harm they cause, and the latter is likely to make additional demands on public spending in some countries. Taken with the chapter on other macroeconomic and financial aspects of climate change in the Spring 2008 *World Economic Outlook*, the staff paper provided background for a discussion of both technical issues and, more generally, the role of the IMF in this area.

Executive Board Assessment

Directors welcomed the opportunity to discuss the fiscal implications of climate change and the potential role of the Fund in helping its members address these implications. The staff paper prepared for this seminar, together with the chapter on the economics of climate change in the Spring 2008 *World Economic Outlook*, were generally viewed as useful contributions to the debate on a complex topic of global concern. Directors noted that, while much of the damage that might be caused by climate change remains many years away, moderating it is generally believed to require reducing emissions of greenhouse gases in the near term. They recognized that many low-income members—among them low-lying developing countries and small island

[1] At the conclusion of the discussion of the Seminar on the Fiscal Implications of Climate Change, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is posted at the IMF website.

nations—may be disproportionately affected, making the adaptation to climate change in these countries a pressing concern.

Directors expressed a variety of views on the implications of climate change for the fiscal work of the Fund, providing useful guidance to the staff on how to move prudently forward in this area. The overall sense of today's discussion is that the Fund has a distinctive and valuable contribution to make to the task of understanding and dealing with the fiscal challenges from climate change, but that this contribution needs to be well-focused and subject to clear boundaries. The Fund's work on climate change should be budget-neutral, especially in the current refocusing context, and should be limited to the Fund's core competencies. This means that the Fund should not seek to acquire additional expertise on environmental issues or duplicate the work of other organizations, such as the United Nations and the World Bank, on which it should continue to draw as appropriate.

With respect to the ongoing international dialogue on climate change, Directors agreed that the Fund should not take the lead in tackling climate change issues. Some Directors would prefer to see wider consultations with other institutions and a clearer sense of direction from the negotiations under the United Nations framework before coming to a firm view on what the Fund's role should be in this area. Taking into account this need for restraint, Directors generally encouraged staff to follow the negotiations underway toward a successor agreement to the Kyoto Protocol—given the difficult fiscal policy cooperation and design issues that will need to be faced—and to contribute on aspects within the Fund's established mandate and expertise.

With respect to the Fund's country work, Directors broadly shared the view that the Fund is well-placed to advise members prudently and on a limited scale on macroeconomically relevant fiscal aspects of climate change through its surveillance and technical assistance. They noted that climate change concerns tend to reinforce established Fund advice on fiscal management, for instance in relation to energy subsidies. At the same time, many Directors cautioned against putting a particular emphasis on climate change in the Fund's surveillance and technical assistance work, or making climate change issues a standard part of Fund surveillance. It was suggested that the Fund's work in this area should be mainly demand-driven, pay special attention to countries where the impact of climate change on external stability is evident and significant, and facilitate the exchange of views on country-experiences.

Turning to the fiscal policy issues addressed in the staff paper, Directors acknowledged that policy formulation to deal with the effects of climate change is made especially challenging by the difficulty in attributing specific weather-related events to climate change. Even when the macroeconomic effects of climate change are clearly identified, policy action is further complicated by uncertainties regarding the size and timing of the effects; by the slow process of climate change; by the role of past emissions in contributing to future climate developments; by the need for international cooperation to harmonize policies, deal with international spillovers, and address difficult distributional issues across countries; and by a range of technical issues in instrument design and implementation. These considerations seem to favor a gradual and flexible approach, with emphasis on policies that can be easily modified over time.

Directors noted the potential role of regulation in mitigating emissions and of private sector actions to adapt to climate change, including through innovation and the development of financial instruments. At the same time, fiscal instruments will, in many countries, help to ensure effective pricing of emissions and to provide a supportive environment for innovation. They would also help finance and foster appropriate adaptation to remaining effects of climate change.

Directors noted the wide range of fiscal instruments that could be used for mitigation. An important first step in many countries is to scale back implicit or explicit energy subsidies. Beyond that, cap-and-trade schemes, carbon taxation, and hybrids of the two could be used to shift incentives in an appropriate direction. The choice among these instruments needs to be informed by careful analysis of their feasibility and fiscal consequences, of the scope for using the revenue they might raise to improve national tax systems or finance priority expenditures, of their wider implications for international macroeconomic performance, and of their capacity to foster broad participation by countries. Several Directors highlighted in particular the challenges that would be involved in the international coordination of tax rates.

Recognizing that the debate on these issues is in many respects still at an early stage, Directors noted that attention also needs to be given to other fiscal aspects of mitigation. The design of measures to offset the regressive impact of carbon taxation and the elimination of fuel subsidies is a delicate issue. While acknowledging that revenue earmarking generally introduces undesirable inflexibility in fiscal management, some Directors nevertheless saw merit in the well-targeted use of carbon tax revenues to compensate vulnerable groups.

Directors considered that, in those countries particularly exposed to climate risk, adaptation may impose significant pressures on public sector spending. In many cases, a better understanding of the macro significance of these pressures and of the fiscal risks and trade-offs from climate developments will be needed. Where feasible, the creation of fiscal space to deal with spending pressures may need to be considered. More broadly, Directors emphasized the importance of international efforts to support adaptation programs in low-income countries through a variety of instruments adapted to their specific circumstances. They welcomed the continued exploration of regional initiatives, and encouraged the international community to continue to stand ready to provide financial assistance as needed.