



Chapter 4

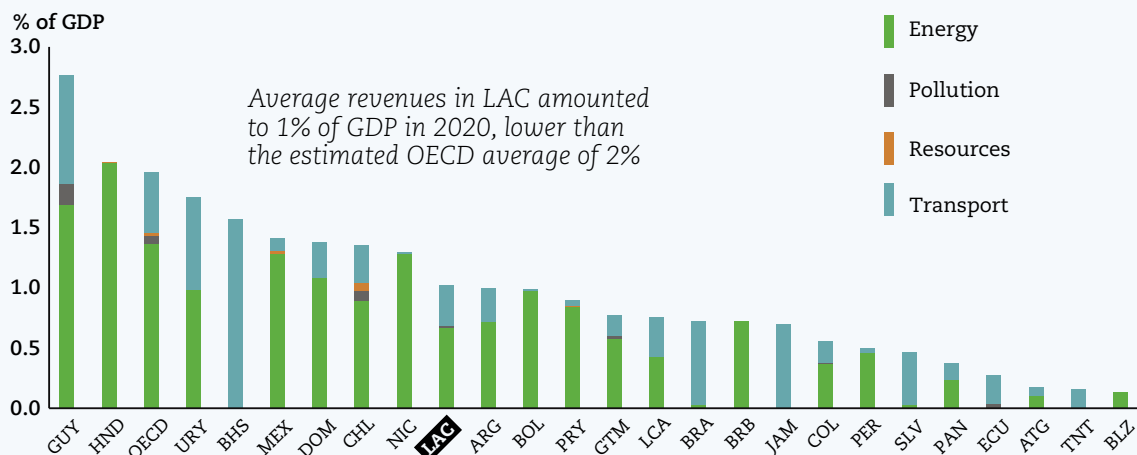
How to make it possible? Financing a green and just transition

To transition to net-zero emissions economies, the LAC region must mobilise substantial resources in a tight fiscal space. To do this, the region needs an effective financing strategy that involves the public and private sectors. This chapter analyses a sustainable fiscal policy that aims to invest more and better in the green transition, with a focus on the energy sector. It proposes ways in which the region can mobilise further resources, specifically through environmental taxes, innovative debt tools, and phasing out fossil fuel subsidies (without neglecting the most vulnerable). It stresses the need for sustainable financial strategies that channel public and private investment towards projects with greater environmental benefits. It focuses on the role of finance ministries and that of sub-national, national and international development finance institutions (DFIs) in helping mobilise resources for the green transition. It also suggests strategies to help the public sector mobilise private-sector investments towards sustainable projects. Finally, it looks at the importance of sustainable finance frameworks in developing and improving regulatory guidelines that facilitate private- and public-sector investments.

Both the public and the private sectors are needed to finance the green transition in LAC

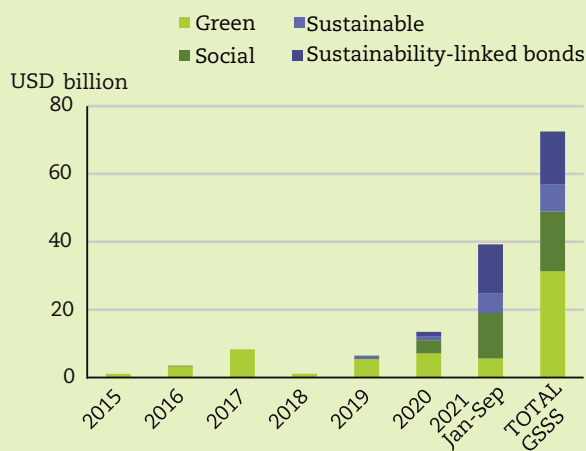
To fund a green transition the region must **levy further resources** through environmental taxes, emissions trading systems and a step-by-step phase-out of fossil-fuel subsidies

Environmentally-related tax revenue in LAC countries, by main tax base, 2020

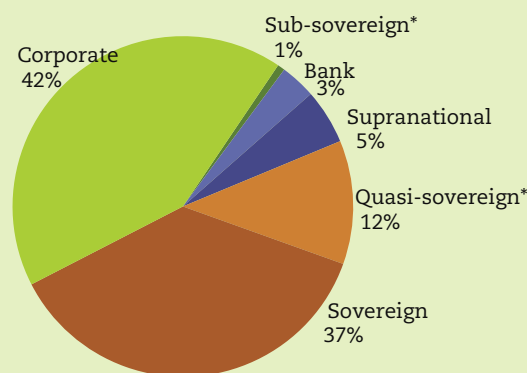


To mobilise the vast amount of funds needed for the green transition, the pool of **stakeholders and tools** will also have to be enlarged

In LAC, the GSSS market has been growing since 2015 reaching an accumulated USD 73 billion in September 2021



Total LAC GSSS bond issuance in international markets, by type of issuer, December 2014 to September 2021



*Sub-sovereign refers to states, cities and provinces. Quasi-sovereign issuers are defined as companies with full or partial government ownership.



The role of national and sub-national development banks is key in leveraging private-sector resources



Sustainable finance frameworks should maintain transparency and avoid greenwashing by improving regulatory tools, such as sustainability and green bond standards and taxonomies

LAC faces the challenge of financing the green transition under a tight fiscal space in a context of persistent social inequality and historic development challenges. In answer to the coronavirus (COVID-19) crisis, the region expanded social spending while experiencing a drop in revenues, resulting in a strong increase in public debt. With reduced fiscal leeway, most LAC countries must align recovery stimulus with achieving sustainability targets, while protecting the most vulnerable (Chapter 1).

To finance the green transition, the region needs to invest more, while mobilising further resources from public and private sources. The cost of inaction is high, for instance a 2.5°C rise in temperature could cost the region between 1.5% and 5.0% of gross domestic product (GDP) by 2050 (Bárcena et al., 2015^[1]). Thus, it is important to seek and scale up innovative financial instruments and develop strategies that enable LAC countries to achieve both their Nationally Determined Contributions (NDCs) and their commitment to the United Nations Sustainable Development Goals (SDGs). Specifically, countries need to increase and improve public and private spending on clean energy and energy efficiency, since these are the most cost-effective ways to reduce emissions on a global scale (IEA, 2021^[2]). This should be coupled with the development of well-defined renewable energy infrastructure investment plans, also known as “robust low-carbon infrastructure project pipelines”, that specify what and where project investments are needed, when they should be built, how to finance them, or if they are sufficient to meet long-term objectives (OECD, 2018^[3]). The region also needs a “big push” towards developing innovative ways to mobilise public and private resources. Environmentally related taxes present themselves as an important opportunity, as they can raise additional revenues, create the right behavioural incentives, and accelerate the green transition. Similarly, rationalising and phasing out fossil fuel subsidies, particularly the ones that benefit the affluent population, is also a way to liberate further resources. Likewise, scaling up debt tools, such as green, social, sustainable, and sustainability-linked (GSSS) bonds, debt-for-nature swaps, catastrophe (CAT) bonds, and natural disaster clauses, will be critical.

Developing the right compensation schemes will be necessary as the green transition advances. The effects of climate change and the policies necessary to address them will leave certain sectors of the population in a more vulnerable state, for instance as a result of job loss in certain sectors. Compensation schemes need to include cash transfers, in-kind transfers, unemployment benefits for workers dismissed active labour market policies (ALMPs) (Chapter 3) and expanded social protection systems for the most vulnerable (Chapter 1). Compensation policies can also include facilitating relocation and retraining of workers, promoting decent work in rural areas, offering new business models, and supporting displaced workers.

Sustainable finance strategies that involve a diverse pool of stakeholders are essential to guide the green transition. Finance ministries have the important role of developing fiscal frameworks that protect green investments and thus ensuring that the ecological transition becomes a long-term priority. An important step is to align national expenditure and revenue processes with climate and other environmental goals. Similarly, the use of innovative tools such as a “green golden rule” could also prove to be useful. National and sub-national development banks can also help by providing technical and financial support for the design of climate and financial strategies (Finance in Common, 2021^[4]; Galindo, Hoffman and Vogt-Schilb, 2022^[5]).

Climate-related development finance also plays a key role in increasing investment in projects with environmental benefits. Here, the expansion of green financing by bilateral, multilateral, and private donor sources is critical to help countries meet their ambitious climate-related goals. This includes tapping into the growing resources of multilateral climate funds, which include a variety of donors such as multilateral and bilateral actors,

the private sector and donations. Moreover, the improvement of sustainable finance frameworks through public-private co-operation is crucial. These frameworks should enhance regulatory tools, such as sustainable standards and taxonomies that increase the flow of private resources to sustainable projects. Last, since most of the investment for the green transition will come from the private sector, the public sector must put in place the necessary incentives to redirect private-sector investments towards green projects.

While the costs of inaction to fiscal stability have been addressed in Chapter 1, this chapter highlights the importance of developing an environmentally sustainable fiscal policy in the LAC region to drive a green and just transition. This involves a focus on more and better spending on clean energy and energy efficiency, as well as seeking new ways to mobilise additional revenues, such as environmental taxes, emissions trading systems (ETS), phasing out subsidies and scaling up debt tools (e.g. GSSS bonds, debt-for-nature swaps, CAT bonds and natural disaster clauses). The chapter then addresses compensation mechanisms to protect the most vulnerable and those who stand to lose, at least temporarily, from the impacts of green policies. It then focuses on sustainable finance strategies including enhancing green fiscal frameworks (e.g. through green golden rules) and mobilising green investments by key actors (e.g. finance ministries and sub-national, national and international DFIs). The chapter also focuses on financial strategies to increase the mobilisation of private-sector resources and stresses the importance of developing and expanding sustainable finance frameworks that ensure that public and private investments effectively reach environmentally sustainable projects. Lastly, it ends with messages and conclusions.

Developing environmentally sustainable fiscal policies that favour the green transition

To achieve a sustainable and climate resilient net-zero economy, LAC countries have set their own climate mitigation and adaptation targets through their NDCs for 2030, prioritising the energy sector, among others. The energy sector represents the largest source of greenhouse gas (GHG) emissions, accounting for 43.5% of LAC's emissions (Climate Watch, 2022^[6]; FAO, 2022^[7]; OECD/IEA, 2021^[98]). As a result, countries have been shifting their focus towards the energy sector (Chapters 2 and 3).

A successful green fiscal policy in the region aimed at achieving the NDCs, including the more ambitious energy-related emissions targets, will necessarily have to increase spending and incentives on clean energy and energy efficiency while mobilising vast resources through specific tax strategies and novel financial instruments. This needs to be coupled with compensation mechanisms for the most vulnerable to guarantee a just transition.

Increasing spending on clean energy and energy efficiency would be a cost-effective way for the region to meet its net-zero emissions targets

Responding to the climate crisis in LAC requires immediate and better investment in clean energy and energy efficiency (IRENA, 2022^[8]; OECD, 2018^[3]). Globally, these two types of investments could provide more than 90% of the required reductions in energy-related carbon emissions, driven by substantial electrification (IRENA, 2022^[9]). For LAC, this presents a unique opportunity due to the rapid nature of the region's growth and the amount of new equipment and infrastructure being built and purchased, including buildings, factories, vehicles, and networks (IEA, 2021^[2]). The capital intensity of clean energy investment also requires keeping costs from public and private sources low, which will be critical to the speed and affordability of this transformation (IEA, 2021^[2]).

In emerging markets and developing economies, including LAC, clean energy investment needs to increase substantially, especially in electricity generation. If emerging economies are to become net-zero by 2050,¹ investment needs to increase from an average per year of USD 150 billion in 2020 to over USD 1 trillion by 2030. Over the next decade, the largest increase lies in electricity generation, with annual investment going from around USD 0.5 trillion in 2020 to USD 1.6 trillion by 2030 (IEA, 2021). Likewise, if these net-zero economy targets are to be achieved, a transition of the manufacturing industry to low-carbon technologies will be necessary given that this sector is the largest energy consumer and is one of the main sources of CO₂ emissions worldwide, accounting for 40% of total CO₂ emissions (OECD, 2022_[10]).

Additionally, investment in electricity grids needs to increase substantially to accommodate higher electricity demands and the rise in renewables deployment. Since electricity grids are the backbone of power systems, it is necessary to invest in their expansion and modernisation to integrate renewable energies (IEA, 2021_[2]). Similarly, countries, along with the private sector, need to increase spending on electrification via greener buildings, appliances and electric vehicles (EVs). For the latter, governments need to promote investment in public EV chargers to accommodate growing electric mobility needs, develop tax incentives and purchase subsidies, and expand green auto loans and leasing models (IEA, 2021_[2]). A further, more efficient effort, which also deals with the increasing urban traffic congestion in LAC cities, is to promote the vast deployment of structured public electromobility systems (ECLAC, 2020_[11]).

Improving and investing in energy efficiency is the cheapest and most immediate way for LAC countries to start reducing their use of fossil fuels (EESI, 2022_[12]). Increasing spending on eliminating energy waste entails, for instance, investing in energy-efficient, digitally connected buildings driven by climate-based scenarios. These scenarios consider projections of future GHG emissions to assess infrastructures' future vulnerability to climate change. This will have to be accompanied by a substantial shift towards clean solutions to manage the significant rise in demand for cooling. To achieve the goal, governments also have to develop appropriate regulations to increase affordable consumer finance, improve building codes and reduce fossil fuel energy subsidies (IEA, 2021_[2]).

A 'twin transition' approach recognising the importance of progressing both the digital transformation and the green transition in order to reduce emissions will be critical to boost efficiency and serve to build a more inclusive and just energy system in the long term (OECD, 2022_[13]; OECD, forthcoming_[14]). Accelerating the use of digitalised technologies can optimise the deployment of decentralised renewable energy (DRE) by being able to identify who needs energy and deliver it at the right time, in the right place, and at the lowest cost (IEA, 2022_[15]; OECD, 2022_[13]). DRE is renewable energy that, instead of being generated at an energy plant and distributed through a national grid, is generated close to where it will be used and distributed through the grid, mini grids and off-grid installations (UN, 2018_[16]). Governments in the region have the important role of setting up conducive frameworks for the digital transformation of the energy system (IEA, 2022_[15]).

Investing in smart grids with smart meters for better energy distribution in electricity systems is another way to boost energy efficiency. Smart meters enhance efficiency by improving customer demand forecasts and consumer awareness. At least a quadrupling of investment in these is needed by 2030 if LAC countries are to meet their accelerated decarbonisation and electrification aims from their SDG commitments (2030) and their NDCs (IEA, 2021_[2]).

Countries in the LAC region should advance development of their pipelines of robust, low-carbon energy infrastructure projects. By providing more security to investors,

well-defined renewable energy infrastructure plans can guarantee that investments reach sustainable projects (OECD, 2018^[3]). Pipelines and plans help investors identify opportunities among low-carbon infrastructure options that match their needs. Governments can facilitate these processes, for example, by fast-tracking valuable projects or supporting certain projects to overcome barriers to their development (OECD, 2018^[3]).

Phasing out fossil fuel subsidies and introducing environmental taxes can mobilise more revenues while supporting environmental objectives

New investments in the green transition require the mobilisation of additional public resources and fiscal reforms. The LAC region is currently under tight fiscal constraints characterised in most countries by low tax revenues. Thus, to finance the green transition, fiscal policy has to support the recovery. For the green transition, the power of appropriate fiscal reform is that it not only generates more resources but also drives the needed productive transformation, which generates quality formal employment, pushes the green agenda, and protects the most vulnerable (OECD et al., 2021^[17]). Besides alternative options to raise additional resources, further exploiting other policies can achieve multiple targets. These include environmental taxes, ETS or the phase-out of fossil fuel subsidies, particularly to the most affluent population.

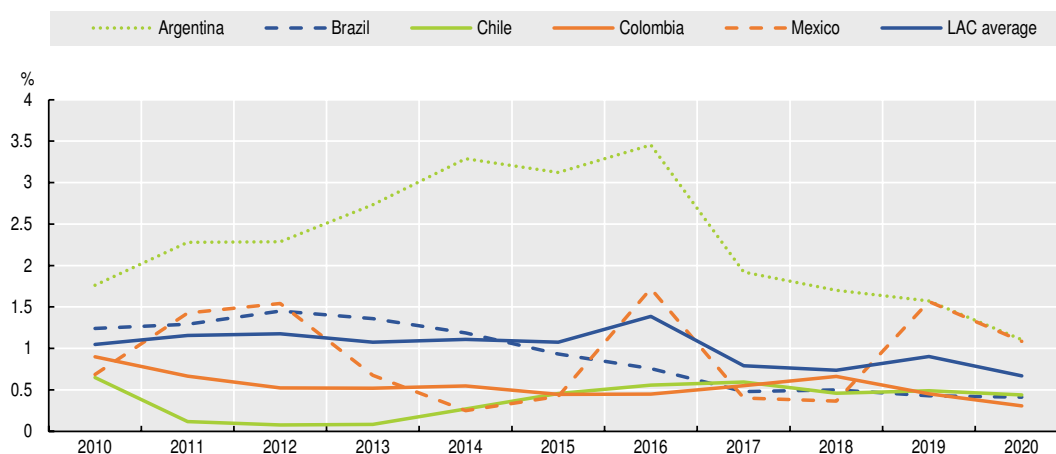
To date, the rationalisation and sequential phase-out of subsidies is an incomplete fiscal policy in the LAC region, even though both could free up resources for projects that have a positive green impact. While some countries have made efforts to eliminate fossil fuel subsidies, such as Mexico through the reduction of fiscal stimulus for the lowest octane fuel in 2022 (Ministry of Finance and Public Credit, 2022^[18]), much more remains to be done. Even if subsidies are intended to protect vulnerable households and firms, evidence shows that, in addition to having a high fiscal cost, they often carry negative distributional impacts (high regressivity); if not adequately targeted, they tend to favour wealthier households that use more fuel and energy.

Many LAC countries provide subsidies for the use of energy products that have negative effects on environment and social dimensions. Reasons for implementing fossil fuel subsidies may include mitigating the impacts of high and volatile petroleum prices, controlling inflation, boosting competitiveness and protecting the poorest segments of the population. However, fossil fuel subsidies can put a strain on national budgets while also benefiting high-income households (Puig and Salinardi, 2015^[19]), increasing air pollution (with associated high health costs), and sending the wrong signals to the markets (negatively affecting social-environmental goals) (Rentschler and Bazilian, 2017^[20]). Generalised fossil fuel subsidies can also contribute directly to urban sprawl, which renders mass transport less effective and results in higher emissions due to greater use of personal vehicles. A green and just transition in LAC requires phased elimination of fossil fuel subsidies, the establishment or adjustment of environmental taxes, and the promotion of productive diversification that expands the tax base. All of these measures should be within the framework of a policy that provides support to firms and households most vulnerable to energy price volatility (ECLAC, 2022^[21]).

Public funds coming from fossil fuels could be redirected to green projects. In 2022, however, the macroeconomic context is hindering this opportunity. Despite an overall downward trend of fossil fuel support measures over recent years, their use is rebounding, and some countries still offer generous support measures that could be redirected towards more efficient sustainable projects. Of the five LAC countries analysed, Argentina and Mexico provided the highest support packages to both consumers and producers in 2020, such that fossil fuel support measures accounted for 1.1% of GDP (Figure 4.1). The LAC

average ranged from 1.0% of GDP in 2010 to 0.7% in 2020, peaking in 2016 at 1.4%. So far, energy tax revenues are greater than the cost of subsidies in the five countries analysed and thus represent, on average, a net positive impact on public finances (OECD, 2021^[23]).

Figure 4.1. Fossil Fuel support measures in LAC



Note: Data include measures benefitting producers or consumers collectively, as both are measures that do not increase current fossil fuel production or consumption but may do so in the future. Examples of General Services Support Estimate (GSSE) measures would include public support for industry-specific infrastructure development (e.g. public support for construction of coal or natural-gas terminals) and government funding for sector-wide R&D related to fossil fuel exploration and transformation. LAC average reflects five countries: Argentina, Brazil, Chile, Colombia and Mexico.

Source: Authors' calculations based on (OECD.Stat, 2020^[22]).

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Understanding the real impact of fossil fuel subsidies and support measures on the most vulnerable should be a priority. Instruments such as direct conditional and unconditional cash transfers offer governments more targeted and cost-efficient approaches to help lower-income households. Even when oil prices remain elevated, governments should shift to such targeted measures, noting that to ensure effective targeting, such a shift will require improvements to existing transfer and social welfare systems (OECD, 2022^[24]).

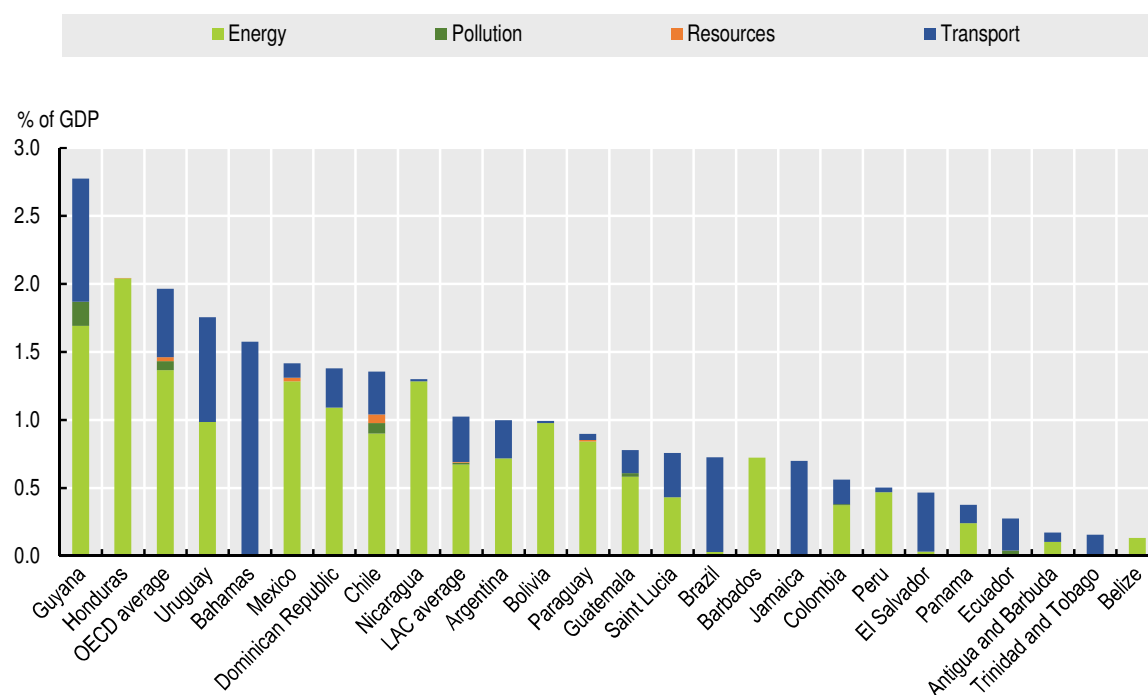
Taking into account the impacts that phasing out these subsidies will have on the most vulnerable populations, as well as the need for gradual reform, is essential to contain potential political backlash. It is important that countries start limiting these types of interventions that dampen incentives to reduce fossil-based energy use. They should instead focus more on building capacity to better address household vulnerabilities to price shocks and accelerate development of alternative sources of energy (OECD, 2022^[24]). Countries should also carry out *ex ante* assessments of the impacts of phasing out subsidies on different segments of the population and provide compensatory measures to mitigate any negative effects. Rather than quickly eradicating subsidies, governments should streamline the reform through a systematic transition that includes: ministerial co-ordination; building trust gradually through socialisation; promoting active government and stakeholder participation; gaining clarity on potential winners and losers through macroeconomic modelling exercises; better targeting support; and communicating changes to all stakeholders (Chapter 5). A step-by-step change in fiscal policy, developed through joint formulation with stakeholders, legitimises the new policy and prioritises medium- and long-term benefits over and above the negative side effects it may have (Coady et al., 2010^[25]).

Any changes to the subsidies and support measures should take into account the current context. Disclosing information on the subsidies through a transparent and clear roadmap could also be key in assessing the benefits and costs for all stakeholders (Coady et al., 2015^[26]). The LAC region is experiencing high energy prices, rising inflation (Chapter 1) and social protests. While the common practice has been to implement such reforms only when the international price of fossil fuels does not show an imminent upward trend (Coady et al., 2015^[26]), the Friends of Fossil Fuel Subsidy Reform (FFFSR), a group of 45 World Trade Organization (WTO) member countries, expressed the need to superimpose long-term environmental goals on short-term ones by working towards reforming regardless of current trends (Geneva Environment Network, 2022^[27]). Benefits to reforming these subsidies continue to accrue with rising oil prices since studies suggest that, on average, 30% of carbon revenues could suffice to compensate poor and vulnerable households, leaving 70% to fund other political priorities (Vogt-Schilb et al., 2019^[28]). Rather than introducing new fossil fuel subsidies, governments should now more than ever use their public resources strategically to reduce the demand for fossil fuels and reduce dependency on these volatile energy sources (Geneva Environment Network, 2022^[27]).

Environmental taxes are underdeveloped in LAC. Economies in the region have been slow to implement them, but environmental taxes and price-based policy instruments are playing an increasing role. These types of policies include price signals to guide consumer decisions, for example by encouraging businesses and households to consider the environmental costs of their behaviour. On average in LAC, environmentally related tax revenues amounted to 1.0% of GDP in 2020, lower than the estimated OECD average of 2.0% of GDP (Figure 4.2) (OECD et al., 2022^[29]). In 2020, revenues from energy taxes (most commonly excises from diesel and petrol) generated the highest share of total environmentally related tax revenues (65.5%), followed by revenues from motor vehicle and transport services (32.5%). There is strong heterogeneity in the region, as environmentally related tax revenues ranged from 0.1% of GDP in Belize to 2.8% in Guyana (OECD et al., 2022^[29]). Most LAC economies do not levy an explicit carbon tax; fuel excise taxes are the most common form of energy tax, while electricity is sometimes also taxed (OECD et al., 2021^[17]). These types of taxes should help modify consumer behaviour towards cleaner energies and transportation modes, thus playing a role in the green transition. As the transition advances, the amount levied by environmental taxes should be reduced.

Enhancing carbon pricing could generate multiple benefits in the LAC region. It provides an incentive for private actors to take production or consumption decisions consistent with global goals to limit climate change and limit health damage from local pollution. Depending on its design features, carbon pricing can also increase revenues that can be used to finance green public-sector investment and guarantee a green and just transition (OECD, 2021^[23]). In a net-zero emission scenario, for hydrocarbon producers such as Brazil, Colombia and Mexico, implementing carbon taxes could generate additional revenues and may alleviate some of the projected fall in hydrocarbon revenues (Chapter 1). However, these revenues could be small for countries that are relatively low consumers of energy, such as Bolivia, Ecuador, and Trinidad and Tobago (Titelman et al., 2022^[30]).

Figure 4.2. Environmentally related tax revenue in LAC countries, by main tax base, 2020



Note: The LAC average represents the unweighted average of 24 LAC countries included in this publication and excludes Cuba, Costa Rica and Venezuela due to data availability issues. The figure does not include Jamaica's revenues from the special consumption tax on petroleum products (estimated to be more than 2.0% of GDP in 2018) (OECD, 2021) as the data were not available. Chile, Colombia and Mexico are also part of the OECD.

Source: (OECD et al., 2022_[29]).

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Carbon pricing can also have negative effects, if certain conditions are not met. If clean and inexpensive alternatives are not readily available, implementing carbon pricing is likely to increase costs for households (IEA, 2021_[2]). Moreover, even if some countries can generate higher revenues from carbon pricing schemes, these can be offset by the need for higher expenditure to cushion the impacts on consumers (section below on protection schemes) (Titelman et al., 2022_[30]). The Helsinki Principles of the Coalition of Finance Ministers for Climate Action is a step in the right direction to enhance carbon pricing. These principles call, above all, for progress towards implementing carbon pricing mechanisms, reducing subsidies that are detrimental to the fight against climate change, and better monitoring of climate finance by governments and financial systems (Bárcena et al., 2020_[31]).

As part of their decarbonisation strategies, some LAC countries have started introducing carbon pricing instruments, including either some kind of carbon tax or an ETS. In the region, efficient fossil fuel pricing mechanisms can raise substantial revenues up to around 2% of GDP (Parry, Black and Vernon, 2021_[36]) (Chapter 6). Among the carbon pricing instruments, ETS are the most cost-effective market-based instruments in generating incentives to reduce emissions. They consist of an emission cap set by the government in specific industries, through which entities covered are allowed to trade emission permits (IEA, 2020_[34]). They also facilitate emissions reduction as polluters for whom it is hard to reduce emissions can buy allowances from polluters who can minimise them at lower costs (OECD, 2022_[35]). Argentina, Chile, Colombia and Mexico have already introduced carbon taxes. In 2020, Mexico became the first country in the region to introduce an ETS pilot programme (World Bank, 2022_[32]). While covering around 40% of national emissions,

the new mitigation policy instrument will give participants time to become familiar with the carbon market, letting regulators test its overall design and sending an initial carbon price signal through the economy (Castro, Vogt-Schilb and Santikarn, 2020^[33]). Colombia, Brazil and Chile have set a timeline to develop an ETS in the next few years (World Bank, 2022^[32]). More recently, hybrid systems with elements of both carbon taxes and ETS have emerged as the most effective way to meet decarbonisation goals (IEA, 2020^[34]).

Green policies need to be accompanied by protection schemes for vulnerable households to limit negative impacts of the green transition and climate change

The effects of climate change, together with some of the undesired consequences of the green transition and its policies, will further expose the most vulnerable, highlighting the need for compensation and mitigation schemes. These can include cash and in-kind transfers, complemented by active labour market policies (ALMPs) and self-employment and entrepreneurship programmes. These are all essential tools to cushion the social costs of decarbonisation, limit the negative impacts on vulnerable households and communities, and allow for a progressive strengthening of countries' social protection systems.

Phasing out fossil fuel subsidies should be done gradually under a wider transition policies package, with good communication mechanisms and accompanied by other compensation and mitigation measures to contain backlash and backsliding. For example, in the case of Indonesia's reform of electricity subsidies and fuel pricing, complementary measures of increased funding for social assistance programmes and infrastructure projects have been key in containing backlash and guaranteeing equity (D'Arcangelo, F. et al., 2022^[37]). To ameliorate the negative impacts on the poor and to increase public acceptability of reform, a robust mix of both mitigation and adaptation measures, together with public information campaigns that highlight rationales and benefits should be considered. Above all, to increase transparency, it is important to highlight how the consequent substantial budget savings could be reallocated to increase welfare. Reallocation could include increased spending and benefits in sectors such as infrastructure, rural development, health, education and agriculture (D'Arcangelo, F. et al., 2022^[37]). Similarly, existing social protection mechanisms should be bolstered with the additional resources (Chapter 1).

Complementary transition support policies should also include helping households cope with energy price hikes through the development of capabilities to adapt to a world of higher energy costs. It is key that governments enable support mechanisms, such as technological change and the development of public transport, that help households develop the capabilities to reduce their energy consumption levels and their energy bills. Income support policies stand out as a good transitional option that protects households to a certain degree without blurring energy price signals, given tax pricing. However, more progressive tax systems alone cannot solve the issue of the negative distributional consequences of carbon taxes and the phasing out of fossil fuels subsidies. Thus, more targeted mechanisms, including social transfers on the basis of constrained energy consumption requirements, need to be developed using carbon tax revenues (Chancel and Ilse, 2014^[38]).

Compensation policies should be complemented by ALMPs and self-employment and entrepreneurship programmes. This would facilitate relocation and retraining of workers, promote decent work in rural areas, offer new business models and support displaced workers (Chapter 3) (IDB/ILO, 2020^[39]). During the transition to a net-zero economy, on average across LAC, brown industries may experience job losses of up to 13.3% of employment compared to the business-as-usual scenario (Chapter 3). However, new

employment opportunities will more than offset these losses by creating up to 15% more jobs in green industries, which normally employ more workers (Chapter 3).

Most countries in the LAC region have cash transfer programmes that are much more cost-effective than energy subsidies and do not provide incentives for increased fossil fuel use (IDB, 2021^[40]). During the COVID-19 pandemic, countries were forced to develop demand policies swiftly, mainly through non-conditional cash transfers and other innovative measures to provide rapid support to public health systems, households and firms. Leveraging this infrastructure and the newly developed targeted transfer mechanisms becomes essential at a time when it is important that compensatory aid reaches the most vulnerable populations (Chapter 1) (OECD et al., 2021^[17]).

Although the cost is lower than energy subsidies, badly designed cash transfer programmes can have some drawbacks. A major fiscal problem is that they can foster informality if they are, in effect, conditional on lacking a formal job (IDB, 2021^[40]). Moreover, once implemented, they can become permanent and represent a fiscal cost year after year. Additionally, their targeting is imperfect, and they may reach some non-poor households, which increases their cost. Last, even though they have multiple social benefits (IDB, 2021^[40]), they do not always cover marginalised populations and households that do not meet the requirements (e.g. when the benefits of low energy prices reach many households).

Tapping into additional resources by scaling up novel debt tools to finance the transition

Green, social, sustainability, and sustainability-linked (GSSS) bonds

As the LAC region faces a tight fiscal space, there is a need to promote and scale up innovative financial instruments to mitigate climate change and achieve sustainable development. On the one hand, the development and strengthening of GSSS bonds increasingly consolidates a capital markets-based approach to sustainable finance that contributes to increased private sector financing. On the other hand, scaling up other mechanisms (e.g. debt-for-nature swaps, catastrophe bonds and catastrophe clauses) is also key to addressing important challenges such as fiscal volatility, stabilising budgets and the need to build up large budget reserves.

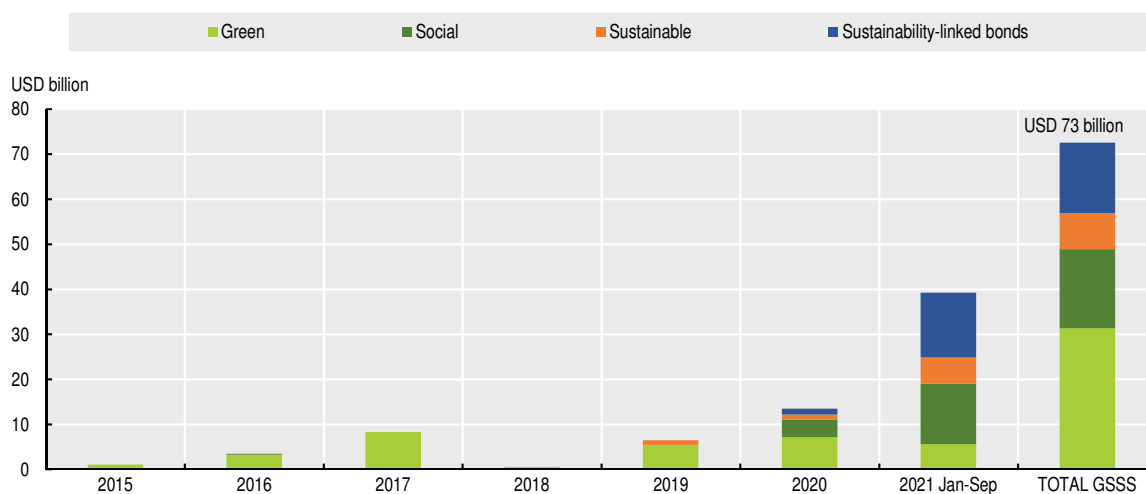
Novel financial instruments, such as GSSS bonds, are already playing an important role in the international debt market. They are incentivising greater participation of governments, corporates and supranational institutions in the debt market. They are also effectively fostering the mobilisation of resources towards sustainable projects in the region. In particular, there are two types of structures in the sustainability debt market: use of proceeds and target-linked. As defined by the International Capital Market Association (ICMA), green, social and sustainability bonds belong to the first type of structure. These are fixed-income instruments whose proceeds are exclusively applied to finance or refinance, entirely or partially, environmental and social projects or a combination of both. In the case of sustainability-linked bonds (SLBs) they are target linked, and proceeds are used for general purposes. They differ from green, social and sustainability bonds in that they are target-linked and allow financing outside of specific projects or use of proceeds categories. SLBs are also more easily tracked through the assessment of key performance indicators (KPI). For SLBs, the issuers choose the associated targets they want to achieve through the issuance of the bond, accruing additional payments to bondholders should they not meet the set target (Núñez, Velloso and Da Silva, 2022^[42]; ICMA, 2022^[41]).

Even though sovereign GSSS bond issuance remains a small part of total external debt, it can play a key role in driving the corporate sustainability debt market. Sovereign

issuers that have the capacity can serve as role models for other types of issuers to generate sustainability standards that are harmonised and have monitoring mechanisms. Sovereign bonds can also broaden and diversify the investor base of issuances. Different stakeholders such as development banks, central banks, bond market associations, structuring consultants, and NGOs are already coming together to support the various stages of issuance, including the design of the specific frameworks (Núñez, Velloso and Da Silva, 2022^[42]).

The region's GSSS bond issuances in international markets have grown substantially since 2015. The GSSS market reached an accumulated USD 73 billion from 2014 to September 2021 of which green bond issuance accounted for USD 31 billion alone followed by social with USD 17 billion. In particular, about 36 distinct LAC issuers accessed the sustainable finance market in 2021, with LAC GSSS bond issuances in international markets reaching a record high of USD 39 billion in the first nine months of the year (Figure 4.3) (Núñez, Velloso and Da Silva, 2022^[42]).

Figure 4.3. Total LAC GSSS bond issuance in international markets, by type of instrument



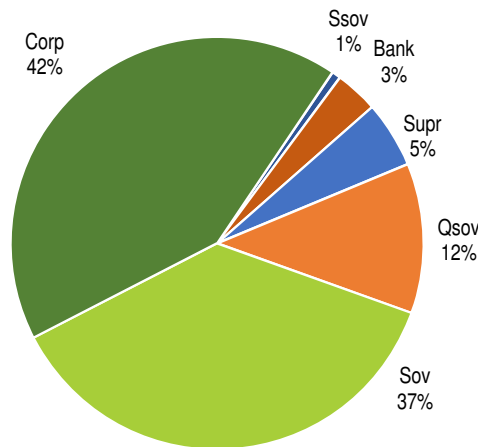
Source: (Núñez, Velloso and Da Silva, 2022^[42]).

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In the early stages, green bonds were the predominant tool, but social, sustainable and sustainability-linked bonds have recently been more common. Since the issuance of the first ten-year green bond of USD 204 million by the Peruvian company *Energía Eólica* in 2014, green bonds became the most used instruments in the region. In 2020, the energy and transport sectors together accounted for 79% of green bond allocations, which went to renewable energy and sustainable mobility projects (ECLAC, 2022^[21]). Although green bonds accounted for the largest share (43%) of the region's total GSSS bond issuance in international markets in the December 2014 to September 2021 period, there was a significant growth of GSSS bonds in the first nine months of 2021. As a result of the market's expansion and the onset of the COVID-19 pandemic, attention has moved from an environment-only focus to a broader perspective that includes addressing social and sustainability concerns. Within GSSS bond in 2021, whereas green bonds accounted for only 14%, SLBs accounted for 37%, the largest share, followed by social bonds (34%) (Núñez, Velloso and Da Silva, 2022^[42]). This follows the incremental growth of GSSS bonds in emerging markets and developing economies (EMDEs) in 2021, largely driven by issuance in LAC, which accounted for 66% of the total (IFC/Amundi, 2022^[43]).

The region's GSSS bond issuances come mainly from ten countries² and two supranational entities, the Development Bank of Latin America (CAF) and the Central American Bank for Economic Integration (CABEI). Chile was the region's largest GSSS bond market at USD 20.9 billion in cumulative issuance in 2021, followed by Brazil (USD 11.1 billion) and Mexico (USD 7.8 billion) (Núñez, Velloso and Da Silva, 2022^[42]; ECLAC, 2022^[44]). While most of Chile's GSSS bond issuance comes from the sovereign sector, Brazilian and Mexican GSSS bond issuances are mostly from the corporate sector (Núñez, Velloso and Da Silva, 2022^[42]). The role of the latter has become increasingly significant in the region, leading the GSSS bond volumes between December 2014 to September 2021 with a share of 42% of the total LAC GSSS bond issuance, while sovereign represented 37%, quasi-sovereign 12% and supranational issuers 5% (Figure 4.4) (Núñez, Velloso and Da Silva, 2022^[42]).

Figure 4.4. Total LAC GSSS bond issuance in international markets, by type of issuer, December 2014 to September 2021



Note: Sov = sovereign. Corp = corporate. Ssov = sub-sovereign (states, cities and provinces). Supr = supranational. Qsov = quasi-sovereign. Quasi-sovereign issuers are defined as companies with full or partial government ownership or control, and supranational issuers as entities formed by two or more central governments to promote economic development for the member countries. The "bank" category refers to commercial banks. Other non-bank financial institutions are included in corporates.

Source: (Núñez, Velloso and Da Silva, 2022^[42]).

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LAC SLBs issued in international bond markets reached USD 17 billion in 2021, all from the corporate sector (Núñez, Velloso and Da Silva, 2022^[42]; ECLAC, 2022^[44]). South America and the Caribbean currently represent approximately 10% of the global market (Environmental Finance Data, 2022^[45]). LAC market leaders when it comes to SLB issuance in international bond markets are Brazil (54%), Mexico (32%) and Chile (8%) (Núñez, Velloso and Da Silva, 2022^[42]). Overall, SLB issuances have been dominated by corporates in LAC; however, sovereigns are starting to use these instruments. Chile issued the world's first sovereign SLB in March 2022, a USD 2 billion issuance, with the two key performance indicators being GHG emissions reduction and scale-up of power generation (S&P Global, 2022^[46]; BNP Paribas, 2022^[47]).

In a COVID-19 context, SLBs appear as an alternative that can help countries tackle economic, social and environmental challenges in a holistic way. SLBs can also be a promising innovation to sharpen investors' focus on supporting the transition strategies of entire companies. SLBs can further develop the key role that debt markets can play in funding and encouraging companies that contribute to sustainability (Núñez, Velloso and Da Silva, 2022^[42]; ICMA, 2022^[41]). Supporting the expansion and fine-tuning of this kind of instrument offers the opportunity to redirect capital flows towards projects that advance

climate change mitigation and adaptation while also addressing social and sustainable dimensions to ensure a green and just transition.

To continue scaling up debt market instruments, governments in the region must work on innovative approaches, for instance issuing green bonds in local currency or fostering digital and technological advances (Box 4.1). The latter can increase debt markets' transparency and make capital much more traceable. While sovereign green bonds can foster investment for the energy transition, leveraging private finance, they also need financial backup from an enhanced fiscal space. Therefore, a fiscal reform, together with deeper changes in the global financial architecture, needs to be orchestrated. Blockchain technology can play a part in solving some of the problems associated with conventional bonds. This involves the ability of various stakeholders to monitor the flow of money, obtain or provide updates on the development status in real time, or demonstrate the impacts of GSSS bonds. A blockchain-supported bond issuance platform can be used to digitalise the whole bond issuing process, which can allow for the establishment of transparent nodes for its effective supervision (Chen and Volz, 2021^[48]). Other key supporting instruments to develop the sustainable bond market include strengthening the role of local and external reviewers and second opinion providers.

Overall, scaling up GSSS and promoting a capital markets-based approach to sustainable finance – coupled with comprehensive frameworks that improve its effectiveness, transparency, comparability and credibility – can contribute to raising vast resources in the region (section below on sustainable finance frameworks) (Núñez, Velloso and Da Silva, 2022^[42]). In the case of LAC countries, meeting the growing demand for quality public services and infrastructure in a tight fiscal context while making them sustainable and climate friendly will require catalysing other sources of financing, especially from the private sector (section below on mobilising private investment flows) (Núñez, Velloso and Da Silva, 2022^[42]).

Box 4.1. Innovative financing tools to enhance local markets and advance in the digital transformation of the region

Upscaling the issuance of sovereign green bonds in the local market

In 2021, Colombia became the first emerging economy to issue a sovereign green bond in local currency in its domestic market (TES Verdes). Due to its innovative nature, it received the “green bond of the year” award from *Environmental Finance* (Environmental Finance, 2022^[49]). To achieve it, the government carried out co-ordinated work between the Ministry of Finance and Public Credit and the National Planning Department, together with other public-sector entities. This process also received technical support from the World Bank and the Inter-American Development Bank (IDB). The first portfolio of eligible green expenditures amounted to COP 2.3 billion (Colombian peso), distributed across 27 projects and 6 categories. Of these, 40% are focused on water management, 27% on the transition of transport towards a cleaner and more sustainable system, 16% on the protection of diversity, and 14% on the transition to non-conventional and renewable energies. The remainder was distributed over waste and circular economy, and sustainable agricultural production.

In addition, the project portfolio was found to be robust in terms of environmental impact and ESG risk management. The total amount issued in 2021 was COP 1.49 trillion, with an initial issuance of COP 750 billion in September. One-third of the issuance (i.e. COP 250 billion) was added thanks to the activation of 50% over-allotment clauses, as there was significant demand for the bond equivalent to 4.61 times the amount initially offered. These clauses worked as a provision that granted the right to sell investors more shares than initially planned. The second

Box 4.1. Innovative financing tools to enhance local markets and advance in the digital transformation of the region (cont.)

auction (in October for COP 650 billion) saw demand from local and foreign investors for 1.5 times the amount initially offered. This type of investment allows the country to provide resources for initiatives with a high socio-environmental impact, thereby strengthening its capacity to respond to unexpected climate and environment events. This type of initiative also facilitates the arrival of new investors that see in these issuances' benefits related to transparency and, in turn, compliance with the guidelines on investments with ESG standards (Ministerio de Hacienda y Crédito Público, 2022^[50]).

Developing digital crowdfunding platforms

In line with the advances in digital transformation in the region, public and private stakeholders can use digital technology as an instrument to mobilise small amounts of domestic savings for sustainable infrastructure investment. Municipalities, along with private finance-sector investors, can come together to develop a digital crowdfunding platform that entails responsible blockchain-based project bonds. The platform can be used to raise finance, while the blockchain is able to record transparently and to certify the use of proceeds, the sustainability impact and the revenue streams of the project.

Blockchain technology continues to attract great attention from financial institutions, energy companies, technical developers, national governments and academia. The Pathfinder Initiative think-tank, along with the Government of Bangladesh, developed an initiative that envisages transforming micro savers into micro investors and reducing the need for international borrowing, using blockchain as a technical backbone to improve the accountability of the funds and returning the dividends from infrastructure investment to the citizens. Scaling this up could be key to mobilising much-needed investment in sustainable and green infrastructure (Chen and Volz, 2021^[48]). Nevertheless, as blockchain is an emerging technology still under development, it is important to consider its downfalls regarding security issues and its potential for high energy consumption. Consideration should be given to addressing these downfalls as these technologies are developed and implemented.

Debt-for-nature swaps

Debt-for-nature swaps can also play an important role in providing additional resources to face the fiscal challenges of the green transition. These swaps can step up as voluntary transactions, where an amount of debt owed by a developing country in the region is cancelled or reduced by a creditor in exchange for the debtor making financial commitments to conservation. For richly biodiverse and highly indebted countries, climate or nature swaps can serve as important sustainable financing instruments. Argentina, Colombia and Ecuador, three heavily indebted countries, have put forward requests for considering these types of initiatives (Arauz, Larrea and Ramos, 2022^[51]). These swaps can result in win-win situations, where countries are allowed to both protect the environment and contribute to face their fiscal challenges. The benefits of redirecting resources towards sustainable infrastructure and green investments are far greater than the costs, as it can avoid the worst impacts of climate change and generate economic, social, fiscal and environmental benefits.

Debt-for-nature swaps have already been used in the region, and new proposals are being drawn up. In the case of Peru, debt swap operations resulted in USD 881.5 million of foreign debt being cancelled between 1992 and 2015, half of which was linked to debt-for-nature swaps, mobilising approximately USD 115 million for conservation.

More recently, a nature swap has been designed between the People's Republic of China (hereafter, 'China') and Ecuador. This proposal considers an Ecuadorian debt exchange with China for conservation through a project with the potential to reduce deforestation by 47% in ten years. This could save 200 000 ha of Amazon rainforest and avoid the emission of 117 million tonnes of carbon dioxide (Mt CO₂) in exchange for a reduction of USD 440 million of debt (Arauz, Larrea and Ramos, 2022^[51]). Debt renegotiations between the two countries are ongoing, taking lessons from the Amazon Fund, an initiative between Brazil and Norway that prompted a decline in deforestation in the Amazon in 2005-12 (Birdsall, Savedoff and Seymour, 2014^[52]).

To scale up this instrument in the present, countries and financial institutions can work on reducing transaction costs. Legal fees and environmental expertise to structure the debt deal significantly increase the costs. A memorandum of understanding (MoU) detailing how the broad parameters of the debt swap will be translated into revised lending agreements can reduce the amount of bilateral back-and-forth needed to agree on the general aspects of debt suspension before addressing the country-specific technical terms and conditions. This type of MoU can help address issues of scale and coverage, and significantly reduce transaction costs (Steele and Pate, 2020^[53]).

CAT bonds

Catastrophe (CAT) bonds are another tool that could help finance the transition. This type of financial instrument provides insurance against losses caused by natural disasters. Additionally, CAT bonds transfer natural disaster risks to global capital markets and thus help governments manage fiscal volatility, stabilise budgets and ease the need to build up large budget reserves (World Bank, 2021^[54]). This tradable financial instrument promises to be one of the most innovative disaster insurance mechanisms (Cavallo, 2017^[55]) by providing key advantages, such as pay-outs based on the severity of the events rather than on the estimates of damages. The benefits encompass pay-outs that can be made quickly and without much contention as soon as catastrophes strike, allowing governments to provide emergency relief before official assistance arrives. Governments and multilateral institutions in the region could subsidise the necessary research associated with calculating the likelihood of natural disasters and the related costs of these events to help face this challenge and grow the market (IDB, 2017^[56]).

CAT bonds can be a useful tool for countries with a higher risk of being struck by natural disasters and are, therefore, more vulnerable to default. Economies vulnerable to default due to natural disasters have rising default risk because of potentially higher fiscal needs in the case of extreme natural events. Consequently, they have higher costs of capital in financial markets and therefore must sell their debt at lower prices with higher yields. CAT bonds can help countries in the region reverse this equation, especially in the Caribbean, the most indebted region in the world, where 50% of the increase in debt is attributable to natural disasters (Persaud, 2022^[57]). CAT bonds can enable these governments to increase their external borrowing from around 30% to more than 60% of GDP, providing welfare gains equivalent to several percentage points of consumption (IDB, 2017^[56]). In 2021, the World Bank issued a USD 185 million cat bond for Jamaica that addresses its financing gap by securing coverage for three hurricane seasons. By entering into an insurance-like risk transfer agreement, Jamaica will be able to receive the funds it needs if future storms exceed pre-defined intensity thresholds (World Bank, 2021^[58]). Work is underway to develop a CAT bond for the Caribbean region with the support of the World Bank, with four countries currently engaged and with the possibility of four others to join (Evans, 2022^[59]).

Natural disaster clauses

Natural disaster clauses can also be an innovative financing instrument to link countries' repayment capacity to their risk exposure. For instance, hurricane clauses were

included as part of a comprehensive restructuring of Grenada's public debt (2013-15) and significantly helped reduce public debt levels from 94% of GDP in 2013 to 56% of GDP in 2019. Hurricane clauses were also part of the debt restructuring (postponement of interest payments) in Barbados (2018-19). These types of clauses are designed to provide cash flow relief at crucial moments when countries experience high needs in terms of financing, and new financial sources might be limited. Embedding hurricane-linked clauses in debt contracts can help LAC countries tap into extended maturity periods in the event of a natural disaster by allowing them to defer either interest or principal payments (or both) for a defined period (ECLAC, 2021^[60]).

Disaster clauses may carry a cost, however, as they incentivise governments to borrow more and pay higher yields (Malucci, 2020^[61]). Introducing disaster clauses entails investors being subjected to the risk of delayed repayments and the need to be compensated accordingly through higher spreads. However, recent analyses suggest that borrowing terms generally improve with the introduction of these clauses (Malucci, 2020^[61]). Study cases evidence how governments take advantage of the better borrowing terms and expand their borrowing up until the point that default risk reaches levels like those observed in the economy without disaster clauses. Since governments expect to postpone repayments, even when spreads increase due to delay risk, the expected cost of servicing debt declines. Thus, with the introduction of disaster clauses, governments tolerate higher spreads, as they have little impact on the overall borrowing costs (Malucci, 2020^[61]).

Designing sustainable financial strategies to support and guide the green transition

Finance ministries have the important role of developing fiscal frameworks that promote and protect green investments

As a fundamental tool for the transition, LAC economies need to develop fiscal frameworks that promote and protect investments, especially green investments, from unsustainable economic and political inertia. In fiscal consolidations, governments find it easier to reduce capital expenditure more than current expenditure (public consumption), despite its potential impact on long-term growth. As composition matters in a fiscal consolidation, when the ratio of public investment declines relative to public consumption, it can produce negative long-term effects on growth. For instance, a consolidation of 1% of GDP reduces output by about 0.5% during fiscal consolidation. This figure increases cumulatively to 0.7% in the three years following the start of consolidation. Protecting investment during the fiscal consolidation can mitigate the economic contraction and, in some cases, lead to an expansion. As a result, the region must protect investment through fiscal frameworks where fiscal rules can be an important tool (Ardanaz et al., 2022^[62]; Ardanaz et al., 2021^[63]).

Even if there is regional heterogeneity in their implementation, fiscal rules are widely used in LAC. Most rules are concentrated in expenditure or budget balance rules, with some economies using a combination of these. For instance, Argentina, the Bahamas, Brazil, Colombia and Costa Rica are currently implementing expenditure rules that aim to set a limit on total, primary or current government expenditures. Similarly, the Bahamas, Brazil, Chile, Colombia, Costa Rica and Peru are using budget balance rules. Last, the Bahamas and Peru are using the debt rule. Some economies base their budget balance rules on fiscal balances that consider the (structural) cycle. Some economies also have clauses that aim to protect investment. For instance, Costa Rica included a golden rule in its framework according to which borrowing can be used only to finance investment spending (Hamid et al., 2022^[64]).

Going forward, fiscal rules must have the flexibility to protect green investment and green golden rules could be considered, especially during fiscal consolidation events. LAC will need to mobilise further resources to finance the transition, while at the same time, some economies of the region will be undergoing a fiscal consolidation process. In this context, a green golden rule (which allows for green investment to be funded by deficits that would not count in the fiscal rules) can be a useful tool to ensure that the adjustment composition does not affect the green transition and that, just like fiscal rules, it sets predictable and consistent capital spending over time (Pekanov and Schratzenstaller, 2020^[65]; Ardanaz et al., 2022^[62]). To be flexible enough in accommodating exogenous shocks to protect investment, fiscal rules can include cyclically adjusted fiscal targets, well-defined escape clauses and differential treatment of investment expenditures. The importance of flexible fiscal rules is evidenced by the fact that economies with no fiscal rules or rigid ones can reduce by 10% their public investment in a 2% of GDP fiscal consolidation. By contrast, in countries with flexible fiscal rules, fiscal consolidation does not affect investment (Ardanaz et al., 2021^[66]). Although the positive effects of protecting investment are well documented, the impact of green investment requires further analysis as, in many cases, the investment would be to replace existing brown infrastructure rather than adding new and clean needed infrastructure (Guntram and Zsolt, 2022^[67]).

Other action areas for finance ministries include developing green budgeting and channelling public investment into environmentally beneficial projects

Evaluating the environmental impacts of budgetary and fiscal policies is essential for governments to achieve their national and international environmental goals. Green budgeting involves the use of budgetary policy-making tools to assess the environmental impact of budgetary and fiscal policies. This can be an important tool for finance ministries to improve the alignment of national expenditure and revenue with climate and other environmental goals (OECD, 2017^[68]). Green budgeting requires that LAC countries effectively incorporate environmental dimensions into their fiscal frameworks (including the annual and multiannual budget documents), evaluate tax and expenditure policies, and consolidate long-term sustainability analyses (OECD, 2017^[68]). Additionally, green budgeting can substantially strengthen green accountability mechanisms, allowing for greater transparency, and thus foster the citizen trust needed to support any future green fiscal reform or climate policy.

Another important role of finance ministries is to channel public investment towards projects with greater environmental benefits. One of the tools to make this possible are lowering social discount rates (SDRs) used to evaluate these projects. SDRs are a type of interest rate applied to specific projects that bring benefits in the future and costs in the present. In the context of climate change policy making, SDRs estimate how much today's society should invest in trying to limit the future impacts of climate change (Grantham Research Institute, 2018^[69]). For instance, the Peruvian Ministry of Economy and Finance uses a general SDR of 8% to evaluate public investment projects and a 4% SDR for projects that provide environmental services that reduce or mitigate GHG emissions (Bárcena et al., 2020^[31]). Applying differentiated rates to low-carbon projects from the outset, when project comparisons are made, is a promising way to shift relative returns in favour of these types of projects. Thus, these rates could be complemented by measures such as efficiency standards and the tax or non-tax price of carbon (Bárcena et al., 2020^[31]). In cost-benefit analyses, studies indicate that keeping SDRs low in the long term supports future generations' well-being, since environmentally important investments, particularly those related to climate change, have inter-temporal and inter-generational equity effects (Bárcena et al., 2020^[31]). The importance of environmental sustainability has led several LAC countries to consider climate change criteria, such as the social cost of carbon, when

evaluating public investment projects (Bárcena et al., 2020^[31]). The Economic Commission for Latin America and the Caribbean (ECLAC), the EUROCLIMA+ programme and the Network of the National Public Investment Systems in Latin America and the Caribbean are currently implementing a regional initiative to promote the use of the social cost of carbon in the evaluation of public investment.

The role of national and sub-national development banks is key in mobilising resources to drive the transition

National development banks (NDBs) can have a significant impact in mobilising resources to drive and support a sustainable recovery. They can provide technical and financial support for the design of climate and financial strategies. In addition, they can promote regulatory and institutional reform plans to help realign both public and private flows, whether domestic or international, with climate change and sustainability goals (Galindo, Hoffman and Vogt-Schilb, 2022^[5]). Through this realignment, they could help address both short- and long-term needs, setting market signals and, when required and feasible, leveraging private-sector financing for sustainable projects. As of February 2021, NDBs in LAC committed to the equivalent of USD 90 billion in financial support to confront the effects of COVID-19 in the region, which includes laying the groundwork for a climate-smart and resilient recovery. This groundwork includes NDBs helping to foster counter-cyclical finance and financial inclusion and promoting environmental sustainability, particularly by combating climate change (Griffith Jones et al., 2021^[70]).

NDBs can also help mobilise and leverage private flows towards low-carbon and climate-resilient pathways, specifically through de-risking and credit enhancement. Credit financing for small and medium-sized enterprises can also foster private-sector participation in new green projects. NDBs can serve as the principal interface between the public and private sectors and are in a unique position to promote economic or social development by financing activities with social returns. They have already been instrumental over the last decade in helping governments green their economies and have developed innovative financial solutions for micro, small and medium enterprises and for infrastructure projects with terms tailored to the financial profile for low-carbon investments. These investments typically require longer tenors, lower (or at least not higher) interest rates, flexible amortisation profiles and alternative collateral approaches (including non-/limited recourse financing). However, most LAC economies are market based, and private capital therefore dominates the financial landscape. Thus, shifting the trillions in private-sector financing into sustainable infrastructure is key to meeting the investment challenge. Many NDBs in the region have taken a leadership role in this domain based on their public development mandates. However, NDBs remain to date an underused conduit for the mobilisation of commercial capital and the intermediation of international climate finance (OECD, 2020^[71]). Finance ministries can be key actors in helping governments align policies and regulations with such investments (Griffith Jones et al., 2021^[70]).

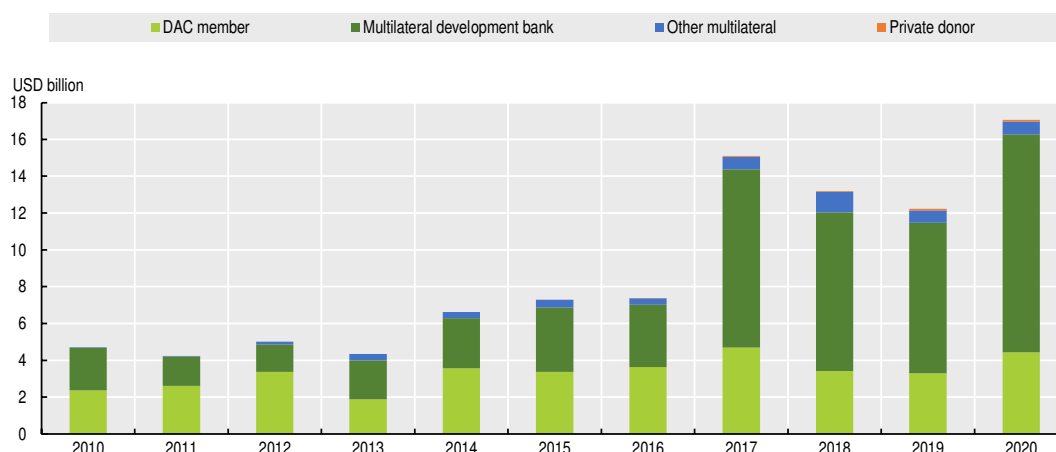
Sub-national development banks (SDBs) can also provide value added within the financing chain. Since less than 10% of international climate finance is currently allocated to local investments, SDBs can help provide an efficient response to close the subnational financial gap (Finance in Common, 2021^[4]). They can also offer a wide range of benefits at the local level such as providing a large panel of financial instruments to unlock and broaden the sources of funding directly or through commercial banks, offer local currency financing and pave the way for the development of stronger subnational financial markets in the long term, especially for intermediary cities (Finance in Common, 2021^[4]). Following the Finance in Common Summit in 2021, the Alliance of Subnational Development Banks in Latin America and the Caribbean was launched, a major step forward to strengthen

financial flows for local and regional governments. One of the main objectives is to align their strategies, norms, standards, investments and portfolios with the 2030 Agenda and its SDGs and the Paris Agreement. This represents a major opportunity to increase the engagement of SDBs in sustainable investments to boost urban and municipal financial markets. It also presents a window of opportunity to help build future low-carbon and climate-resilient cities and territories, and to provide equal access to high-quality services for all (Finance in Common, 2021^[4]).

Climate-related development finance can play an important role in the green transition

Climate-related development finance should increase its role in expanding investments that guide the green transition in the LAC region. Total climate-related development finance from bilateral (OECD Development Assistance Committee [DAC] member countries),³ multilateral (MDBs and other multilateral funds), and private donor sources in LAC reached USD 17 billion in 2020 (OECD, 2020^[78]). MDBs committed most of these resources reaching a total of USD 11.8 billion (69.4%) while DAC members committed USD 4.4 billion (26%), other multilateral funds USD 694.6 million (4.1%), and private donors USD 85.6 million (0.5%) (Figure 4.5). The main financial instruments used by MDBs were debt instruments (77.4%) followed by grants (22.4%), and equity and shares in collective investment vehicles (0.2%). DAC members used grants the most (97.8%) followed by debt instruments (1.8%) and equity and shares (0.3%). Other multilateral funds used grants the most (91.1%), followed by debt instruments (8.0%) and mezzanine finance instruments (0.9%). Private donors' most-used instrument was grants (57%) followed by debt instruments (43%) (OECD, 2020^[78]). Prior to 2017, the share of DAC countries and MDBs in the resource's commitment was almost equal; MDBs have since taken the lead and become key players.

Figure 4.5. Climate-related development finance to LAC by provider type, 2010-20



Note: This dataset includes climate-related development finance from bilateral, multilateral and private philanthropic sources. Both concessional and non-concessional activities are included. Guarantees are excluded because they are categorised as non-flow operations. The total amount of climate-related development finance for each activity is indicated in the field "Climate-related development finance - Commitment". The total amount of climate-related development finance corresponds to the sum of the values of mitigation and of adaptation, minus the Overlap value. For World Bank, Climate Adaptation and Mitigation percentages (%) reflect the share of financial resources committed by the World Bank at Board Approval in support of activities eligible for climate mitigation and/or adaptation finance as per the Joint MDB methodologies for tracking climate change finance. Providers who committed less than USD 120 million total during 2010-20 were not included.

Source: (OECD, 2020^[78]).

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MDBs can structure projects that attract more private lenders while also offering the right protection mechanisms to borrowers. These multilateral funds are instrumental in unlocking additional resources for various projects (see section on blended finance). For example, evidence suggests that, for every USD 1.00 invested in climate action projects in LAC by the IDB, an additional USD 2.60 were leveraged from external climate finance, additional donors, and public and private sources (Viguri et al., 2020^[73]).

Fostering partnerships and co-ordination between MDBs and development agencies is crucial to ramping up green financing (CAF, 2021^[74]). Effective co-ordination with national development agencies can also increase the flow of resources aimed at combatting climate change in the region. For instance, since 2009, the French Development Agency (*Agence française de développement* [AFD]) has committed EUR 11 billion and, in 2020, allocated EUR 2 billion, along with its private-sector arm, Proparco. Not only does its budget support green projects in the region to access loans and credit lines, but 70% of its co-operation projects also focus on the environment, including topics of energy transition, transition towards green taxation and water recycling (Afd, 2022^[75]).

Tapping into the resources of other multilateral institutions, such as climate funds will also be key if countries are to achieve their climate mitigation and adaptation objectives. Multilateral climate funds enable support via funds provided mainly by developed countries targeting a variety of activities (e.g. adaptation, mitigation, REDD, capacity-building) (OECD, 2022^[76]). These funds are also one way in which developed countries are distributing the climate finance they committed to at the 2009 UN conference in Copenhagen, “where by 2020 they would be jointly mobilising USD 100 billion a year to help developing countries tackle climate change” (Carbon Brief, 2017^[72]).

The Green Climate Fund committed the highest amount of resources for the LAC region with USD 538.5 million in 2020, followed by other funds such as the Global Environment Facility General Trust Fund (GEF), the Global Green Growth Institute, and the Climate Investment Funds - Clean Technology Fund (OECD, 2020^[78]). More recently, the Forest Carbon Partnership Facility (FCPF) also took a leading role by paying Costa Rica USD 16.4 million for reducing 3.28 million tons of carbon emissions (MtCO₂) during 2018 and 2019 – making it the first LAC economy to receive payments from a World Bank trust fund. Costa Rica is on track to unlock up to USD 60 million for reducing up to 12 MtCO₂ by the end of 2025 (World Bank, 2022^[77]). Countries must continue ramping up efforts to tap into these funds by developing greater capacity-building and project preparation skills as well as enhancing their use of the National Adaptation Plan (NAP) process.

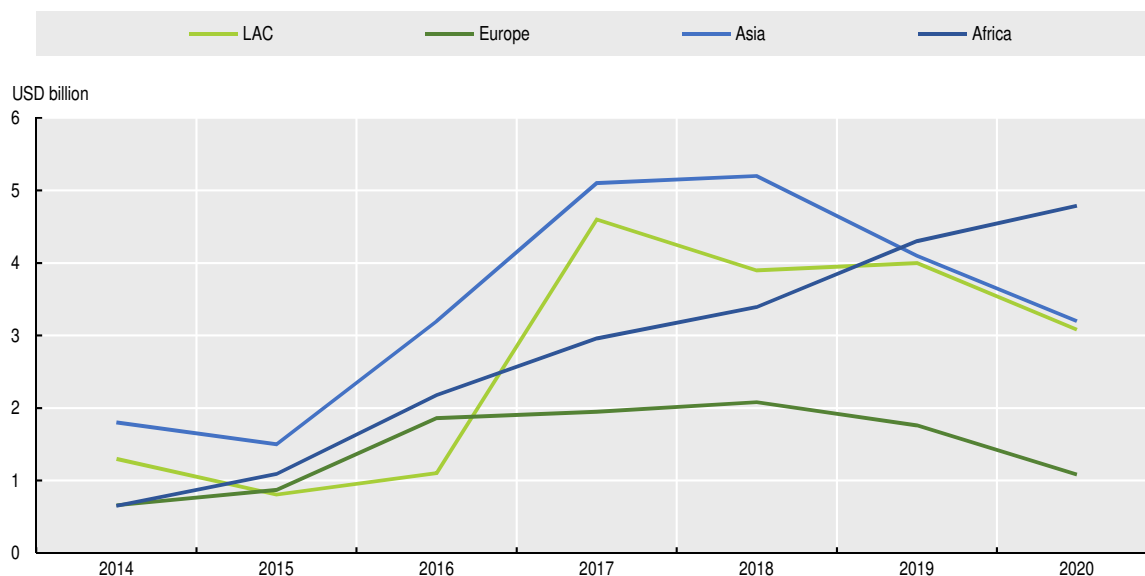
Further expansion of DAC members’ development assistance is also crucial at a moment when this aid lags in some key priority areas, such as climate adaptation (OECD, 2020^[78]). Over the past decade, this assistance has almost doubled from 2.3 billion in 2010 to 4.4 billion in 2020 (Figure 4.5). In 2020, total climate-related development assistance for mitigation dominated climate-related financing efforts with 56% of the share compared to 34% to climate change adaptation (the remaining 10% corresponds to the overlap of both) (OECD, 2020^[78]). On average from 2010 to 2020, adaptation support continued to be less than half of mitigation development assistance. However, in 2021 the OECD DAC Declaration evidenced efforts to increase development assistance for adaptation from developed countries to developing countries, offering a new approach to align development co-operation with the goals of the Paris Agreement. DAC countries committed to use their resources as well as mobilise others to help developing countries access more technical opportunities to enable and accelerate a clean, sustainable and just energy transition (OECD, 2021^[79]).

A shift from the traditional development assistance model to blended finance can multiply the impact of development finance

Blended finance is an innovative tool that can mobilise private resources to finance the green transition. The mechanism's main objective is to attract commercial capital to projects that benefit society while also providing financial returns to investors. Blended finance is defined as *the strategic use of development finance for the mobilisation of additional finance towards sustainable development in developing countries* (OECD, 2018_[80]). In other words, development resources are used as to improve the risk-return profile of individual investments to attract commercial private financing, demonstrate project viability and build markets that ultimately can attract further commercial capital for development (OECD, 2018_[80]). In LAC, since there are insufficient regulatory mechanisms and misperceptions of risk hinder access to finance, especially for SMEs, blended finance could offer a way out. It can also address issues such as financing for renewable mega-projects as well as problems of access to transmission infrastructure since it often involves a high cost of financing.

One way to determine the amount of blended finance that is being deployed in LAC, is by observing the mobilisation of private climate finance by DFIs and MDBs. Despite the benefits of this mobilisation, it has been decreasing in LAC, contrary to other regions. While Africa has experienced a steady increase in the mobilisation of private climate finance by DFIs and MDBs since 2014, this has been decreasing since 2017 for the LAC region (Figure 4.6) (OECD, 2020_[71]). In order to revert this trend continued collaboration between MDBs and NDBs is required, as well as with policy makers and the private sector.

Figure 4.6. Amounts mobilised from the private sector by official development finance interventions, 2014-20



Note: The term “mobilisation” describes the causal link between private finance made available for a specific project and an official intervention. Data are collected following instrument-specific methodologies, covering all leveraging mechanisms used by Development Finance Institutions (DFIs) and Multilateral Development Banks (MDBs): guarantees, syndicated loans, project finance schemes, shares in collective investment vehicles, direct investment in companies, credit lines and simple co-financing.

Source: (OECD.Stat, 2020_[82]).

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The collaborations of private investors with regional development financial institutions can be instrumental to enhance the reach of sustainable investment to markets where

it is yet underdeveloped. Since there is a need to spread the risk burden, these types of partnerships are essential to partially de-risk investments in frontier economies with very shallow capital markets (OECD, 2022^[13]). While MDBs enable the largest share of private-sector investment mobilisation through dedicated private-sector operations, a wide array of actors is also engaging in blended finance, including foundations, philanthropic investors, commercial actors, institutional investors, commercial banks, private equity and venture capital funds, hedge funds, and companies (OECD, 2021^[81]). Development banks and development finance institutions (DFIs) play a critical role in the deployment of the needed instruments and structuring mechanisms (OECD, 2021^[81]).

The public sector is uniquely positioned to mobilise the private investment flows essential for the transition

The public sector and key stakeholders are fundamental to mobilise further private funds for the green transition. LAC has attracted the highest share of private-sector financing for clean energies compared to, for example, sub-Saharan Africa and Southeast Asia. It is crucial for the region to build upon this experience and generate certainty for current and future investments by continuing to strengthen the development of policies, green finance, and regulations that create the adequate conditions (IEA, 2021^[2]).

Governments should support overcoming common risks and barriers to private investment. In energy projects, this includes developing stable, clear and non-retroactive regulations and policies. There is also a need to improve the transparency of processes and timelines for issuing licences and permits to develop projects. Governments should improve the quality and inclusiveness of projects' previous informed consent processes, when required. Similarly, it is essential to enhance local administrative capacity in terms of land acquisition and local content requirements for project approvals. In some markets with enabling reforms, developing new business models is key to attracting private financing that can help bridge existing investment gaps (IEA, 2021^[2]). Public authorities can also help redirect private investment towards climate solutions through concrete regulatory reforms. These include auctions to back the deployment of solar and wind power generation, for example, or effective tax schemes that incentivise renewable energy transport or reforms in bidding processes for bus services (Beltrán et al., 2021^[83]). Governments and finance ministries can enable market structures that improve the participation of private actors and increase the role of competition and transparent pricing in the energy sector. Over time, these actions tend to support investment in clean energies (IEA, 2021^[84]).

Governments should foster and prepare the groundwork for the adoption of responsible banking mechanisms throughout the private banking sector. The role of private banks is vital, as they have the main responsibility for redirecting private flows towards a carbon-neutral scenario. Under the newly installed responsible banking mechanisms, private banks have many ways to reduce climate impacts through their activities. Among the most important channels are: increasing lending to renewable energy projects and public electromobility; eliminating financing for fossil fuel-based projects; issuing SLBs or green bonds where corporate borrowers receive better credit and loans (with lower interest rates) if, for example, they meet climate-related targets; advising and helping investors find and finance green projects; helping green businesses raise funds and pursue deals; and helping corporations find and adopt new technologies that help reduce CO₂ emissions (Santander, 2021^[85]). However, a more systemic way to redirect private finance towards the energy transition entails the incorporation of climate-related financial risks in their daily operations, as it is for their own interest to mitigate and manage these risks (see sub-section on corporate sustainability standards: approaches such as that of the Task Force on Climate-Related Financial Disclosure and the International Accounting Standards Board).

Improving sustainable finance frameworks is crucial to enable and scale up green investments

Sustainable finance frameworks are essential to maintain and increase public and private green investments. These are regulatory guidelines developed by both public and private finance-sector stakeholders that serve to reduce and manage environmental, social and governance (ESG) risks from financial activities, and encourage the flow of capital to assets, projects, sectors and businesses that have environmental, climate and social benefits (SBFN/IFC, 2021^[86]). These guidelines are essential to achieve transparency, reduce transaction costs, and facilitate private and public sector flows. They are also conducive to an increase and more efficient allocation of resources to sustainable projects. Given that the transition will mainly be financed by the private sector, regulatory tools (e.g. sustainability standards or taxonomies) will also be essential for investors to meet regulatory requirements, reduce risks exposure and avoid greenwashing.

There has been a progressive increase in implementing sustainable finance frameworks in LAC. Since 2010, the number of frameworks has almost doubled with governments playing a leading role in the formulation of green and sustainable finance protocols. Overall, the non-banking sector has had the lowest participation, which highlights the need for LAC countries to deepen and broaden implementation of sustainable finance frameworks in the rest of the financial ecosystem. For instance, Colombia's framework extended its coverage from the banking sector to the pensions, capital markets and asset management sectors. Broadening the understanding of national sustainable finance roadmaps is essential to recognising the diversity of approaches and starting points, including the potential leadership role of all parts of the financial sector (SBFN/IFC, 2021^[86]).

The Sustainable Banking and Finance Framework (SBFN) and the International Finance Corporation (IFC) of the World Bank Group have developed a methodology to assess developing countries' progress on sustainable finance frameworks. The SBFN, the first global network of its kind focused on sustainable finance at the market level, represents 43 developing countries and USD 43 trillion (86%) of the total banking assets in emerging markets (SBFN/IFC, 2021^[86]). Its methodology consists of assessing three main pillars: 1) ESG integration, which refers to the management of ESG risks in the governance, operations, lending and investment activities of financial institutions; 2) climate risk management, which refers to new governance, risk management and disclosure practices that financial institutions can use to mitigate and adapt to climate change; and 3) financing sustainability, which refers to initiatives by regulators and financial institutions to unlock capital flows for activities that support climate, green economy and social goals. This pillar includes the development of new products and initiatives, such as green bonds, sustainability-linked loans, definitions, guidance, taxonomies, monitoring and incentives (SBFN/IFC, 2021^[86]).

Most LAC countries are at a formulation or early implementation stage of financial frameworks, with a setback in climate risk management. Brazil, Colombia and Mexico are leading efforts in these areas. Through the formulation of agreements among the banking, non-banking and government sectors, these three countries are either at an advanced stage of implementation or a maturing stage of consolidation regarding at least two of the three pillars of financial sustainability. The main challenge remains in climate risk management as the region is one of the most prone to increasingly frequent natural disasters. It is therefore critical that countries work to enhance this pillar by requiring financial institutions to identify, measure and report the exposure of the sectors that are most vulnerable to transition and physical risks (SBFN/IFC, 2021^[86]).

Given that the transition in the LAC region will mostly be financed by the private sector, it is key to develop a variety of mitigation and adaptation policies to ensure investments flow into assets aligned with transition objectives. To do this, it is essential to develop regulatory tools (e.g. sustainability, green bond standards, or taxonomies) within national sustainable finance frameworks. These tools promote transparency, comparability and credibility for investors while helping to avoid greenwashing. As the number of investors wanting to participate in the debt markets is increasing, these tools have become extremely necessary so that investors effectively meet disclosure requirements for financial and non-financial undertakings.

Countries in the region should continue to develop clear green bond and corporate sustainability standards. These are voluntary, usually third party-assessed, norms and standards relating to environmental, social, and governance issues adopted by concerned stakeholders (e.g. producers, traders, manufacturers, retailers or service providers) and used to qualify their performance in achieving sustainability-related targets. These can foster investor protection and avoid greenwashing of bonds, products or services marketed as sustainable. Governments must also ensure that both green and corporate sustainability standards are aligned with international practice:

- First, regarding green bond standards, the European Union Green Bond Standard can serve as a good example for LAC to continue consolidating a harmonised standard that all the countries in the region can follow. This could guarantee the development of quantifiable green targets with which issuers can ultimately reach climate neutrality by 2050 with reduced transaction costs (EU Green Bond Standard Working Group, 2019^[87]).
- Second, regarding corporate sustainability standards, approaches such as that of the Task Force on Climate-Related Financial Disclosure and the International Accounting Standards Board are key to expanding efforts in standardising climate-related financial disclosures. These have been widely used as a reference by companies in their ESG standards (Núñez, Velloso and Da Silva, 2022^[42]). In particular, the creation of the International Sustainability Standards Board, launched at COP26 in November 2021 and signed by three Latin American countries (Brazil, Mexico and Uruguay), was a first step towards harmonising sustainable methodologies with a benchmark that all countries can follow. The initiative focuses on developing a global sustainability baseline to meet investor needs for information on company ESG strategies (including physical and transition risks), which have an impact on the value of their business. This would address investor demand for globally comparable sustainability information that is consistent with financial statements.
- While the implementation of voluntary standards has been the common practice, in the last few years, mandatory standards have become increasingly important amongst large companies and bond issuers. However, it is important that governments consider that mandatory standards as a condition for issuance could discourage some issuers (Núñez, Velloso and Da Silva, 2022^[42]). Mandatory standards should be imposed gradually and on pace with the development and strengthening of capacities in the local sustainable finance ecosystem.

Regulatory tools and classification systems such as green, transition or sustainable taxonomies, can also increase transparency and comparability for the private sector's financial activities. These can help identify sectors associated to specific portfolios that are directly exposed to physical and transition climate risks (Box 4.2). For instance, private banks' internal climate change risk taxonomies enable them to track their activities, support product development, avoid greenwashing and reinforce their transparency and

commitment to promote and increase their green, social and sustainability-linked activity (Santander, 2021_[85]). These mechanisms also help banks decarbonise their portfolios and reduce climate-related risk, including via new criteria that prohibit financing and advising on new upstream oil clients (except for transactions for financing renewable energy) and direct financing of upstream oil greenfield projects (Santander, 2021_[85]).

Working to harmonise such taxonomies across the region is also key to fostering certainty, credibility integrity and transparency in the market. This could enable further mobilisation of capital aligned to countries' environmental goals. To achieve this, the Working Group on Sustainable Finance Taxonomies in Latin America and the Caribbean⁴ is developing a common regional framework of sustainable finance taxonomies. As there are at least six taxonomies under development or implemented in LAC, the initiative seeks to support policy makers, financial regulators and supervisors, banks, investors, and international organisation specialists to understand and build a common language and a science-based definition of what sustainable finance is – and what it is not (UNDP, 2022_[88]). This would improve interoperability with global taxonomies and reduce transaction costs to interested investors while fostering participatory processes and collaborative work across financial stakeholders.

Box 4.2. Green, transition and sustainable taxonomies in LAC

The increasing ambition of national and international climate targets, including in response to the already severe impacts of climate change in many regions, helped drive the creation of sustainable and green finance frameworks and standards. While the most focus to date has been on green finance and defining demonstrably low-emission activities as part of green taxonomies, increasing attention is now being paid to transition finance and the need to provide more capital to enable high-emitting activities to progressively shift or transition to lower emissions while avoiding emission lock-in. Three core eligibility criteria for transition finance can be distilled from currently existing approaches: (i) substitutability (absence of a zero or near-zero alternative), (ii) a commitment by the borrower/issuer to a low-emissions trajectory; and (iii) avoiding lock-in of emissions (Tandon, 2021_[89]). However, differences in existing transition finance approaches developed to date can fragment markets, reduce investor confidence and create greenwashing risks. To address these gaps and ensure environmental integrity, the OECD is currently developing Guidance on Transition Finance, with a focus on corporate climate transition plans (OECD, 2022_[90]).

While there is currently no specific transition taxonomy in LAC, a few countries have developed or are in the process of developing sustainable or green finance taxonomies, including Brazil, Colombia, Chile, the Dominican Republic and Mexico. The Colombian government is leading the way with the publication of its green taxonomy in April 2022 (Responsible Investor, 2022_[91]). The taxonomy seeks to facilitate the identification of projects with environmental objectives, develop capital markets, and promote the effective mobilisation of private and public resources (Government of Colombia, 2022_[92]).

In other countries, various initiatives to implement a national taxonomy are under development (Table 4.2). In Chile, the Climate Bonds Initiative (CBI), along with Chile's Ministry of Finance, the Green Finance Public-Private Roundtable and the IDB, has created a roadmap for a national taxonomy, focusing on key economic sectors, including the high-emitting sectors of construction, energy, transport and mining (Climate Bonds Initiative, 2021_[93]). In Mexico, a comprehensive effort involving many bilateral and multilateral actors is supporting the Mexican Committee on

Box 4.2. Green, transition and sustainable taxonomies in LAC (cont.)

Sustainable Finance (composed of the Ministry of Finance, the Central Bank [Banxico] and the financial regulatory commissions) in the development of a national taxonomy. Many international organisations, including ECLAC, the World Bank and bilateral aid agencies are supporting the Mexican Ministry of Finance in the development of a national taxonomy. *The Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ)* worked both with the Mexican banks association on a green taxonomy for the financial system (Muller et al., 2020^[94]) and with the Ministry of Economy in Brazil on the development of a green taxonomy (GIZ, 2018^[95]). In Peru, the Climate & Company think tank, in partnership with the Peruvian Ministry of Environment and the GIZ, is exploring the benefits of a national sustainable taxonomy based on the World Bank's recommendations (Climate & Company, 2022^[96]). The IFC signed an MOU with the Securities Superintendence of the Dominican Republic and the Ministry of the Environment, which is expected to lead to the development of a consolidated taxonomy (Climate Bonds Initiative, 2021^[93]).

Table 4.1. Overview: Selected LAC countries with taxonomy initiatives

Country	Chile	Colombia	Dominican Republic	Mexico	Peru	Brazil
Stage of taxonomy development	Roadmap proposed	Initial documents published	Under development	Under development	Research underway	Under development
Participants	CBI, IDB, Ministry of Finance	Government ministries	IFC, government ministries	GIZ, AfD, ECLAC, IFC, GGGI, UK PACT, Bank of Mexico, World Bank, Ministry of Finance	Ministry of Environment, GIZ	Ministry of Finance, GIZ

Sources: (Government of Colombia, 2022^[92]); (Climate Bonds Initiative, 2021^[93]); (Climate & Company, 2022^[96]); (IFC, 2021^[97]); (GIZ, 2018^[95]).

It is important that LAC countries push for further implementation and integration of these frameworks and tools to enable more effective and transparent flow of sustainable finance, especially from the private sector. Advancing towards more mature, sustainable finance ecosystems in the region can contribute to generating more consistent and comparable data about sustainable finance implementation by financial institutions on both the risk management and opportunity sides. It also contributes to better reporting requirements for the purposes of regulation and supervision and allow investors and stakeholders to better understand the sustainability performance of financial institutions and companies (SBFN/IFC, 2021^[86]). With a view to promoting sustainable finance frameworks that are anchored in the region's digital transformation, they can also help increase digitisation in the region by recognising the role of telecommunication networks and favouring their financing. Countries that act late to strengthen their frameworks and tools risk putting their financial institutions at a disadvantage. Lack of alignment with other markets may create costs and inefficiencies for cross-border sustainable finance activities. The expansion and deepening of these frameworks throughout the finance sector can serve as a foundation for increasing competitiveness, investment opportunities and impact (SBFN/IFC, 2021^[86]).

Key policy messages

Under a tight fiscal space, LAC countries must develop and scale up sustainable fiscal frameworks and financial strategies that can effectively guide a green and just transition.

To finance the green transition, LAC economies need to ramp up investment and mobilise further resources from both public and private sources. To achieve a net-zero emissions economy, increased spending on clean energy and energy efficiency will be essential. To mobilise the necessary funds, the correct incentives must be put in place, fossil fuel subsidies phased-out, and further resources levied through environmental taxes and ETS. During this process, and because of, climate change policies must also aim to ensure a just transition by compensating the most vulnerable. To mobilise further resources, the upscaling of debt instruments such as GSSS bonds, debt-for-nature swaps, CAT bonds, and natural disaster clauses will be crucial. Investments in the green transition must be channelled and protected by fiscal frameworks and green budgeting. In addition, sub-national, national and international development institutions must be supported since they play a crucial role in further mobilising public and private resources. Finally, to maintain transparency and avoid green washing on green investments, finance frameworks will be essential through several regulatory tools (e.g. sustainability and green bonds standards and taxonomies).

Climate-related development finance from bilateral, multilateral and donor sources also play a key role in increasing investment in projects with environmental benefits. Here, tapping into the growing resources of multilateral climate funds – which include funds provided mainly by developed countries – is also key to achieving environmental goals.

Box 4.3. Key policy messages

Encourage environmentally sustainable fiscal policies

- Promote more and better spending on clean energy and energy efficiency:
 - Increase investment in technologies for electricity generation and storage, including electricity grids and battery storage, to accommodate higher electricity demand and the surge in renewables deployment.
 - Invest in and improve energy efficiency since it is the cheapest and most immediate way to reduce the use of fossil fuels. Investing in digitalised energy systems will also boost efficiency and serve to build a more inclusive and just energy transition in the long term.
 - Develop pipelines/plans for low-carbon infrastructure projects to ensure available private and public investments for renewable energy reach sustainable projects. Such pipelines entail developing investment-ready and bankable projects that investors and project developers can trust and back.
- Better align environmentally related taxes and subsidies with the cost of pollution:
 - Rationalise and phase out unjustified fossil fuel subsidies, particularly to the most affluent population, to free additional revenues to finance the transition and avoid perverse incentives for fossil fuel use.
 - Increase revenues from environmental taxes. These are crucial as they include price signals that aim to factor into consumer decisions and encourage businesses and households to modify behaviour. The revenues of these taxes will start declining when consumers modify their behaviour towards cleaner energies and transportation modes.
 - Work further in the consolidation of carbon pricing instruments that generate an ambitious climate policy and include hybrid systems with elements of both carbon taxes and ETS.

Box 4.3. Key policy messages (cont.)

- Develop compensation mechanisms for vulnerable households affected negatively by climate reform policies:
 - Further help vulnerable households cope with energy price hikes through complementary transition support policies that enable them to adapt to a world of higher energy costs.
 - Leverage already developed targeted transfer infrastructure to make sure compensatory aid reaches the most vulnerable populations.
- Promote and scale-up debt tools that can help raise additional revenues to ensure flows of resources target climate action, comply with climate spending targets, and build sustainable and economically viable portfolios:
 - Scale up GSSS bonds by enhancing the domestic debt market, working towards the issuance of bonds in local currency and fostering digital and technological advances.
 - Support the expansion and improvement of SLBs, as they offer an opportunity to redirect capital flows towards projects that address climate change mitigation and adaptation while accounting for social and sustainable dimensions to ensure an inclusive and just transition.
 - Participate in debt-for-nature swaps that can further finance the green transition by releasing debt burdens and increasing spending on environment-oriented projects. This mechanism can be scaled up by reducing transaction costs through MoUs, which can help address issues of scale and coverage.
 - Develop tradable financial instruments, such as CAT bonds, that can help spread risk across global capital markets while swiftly providing necessary natural disaster relief resources. Increase subsidies for necessary research associated with calculating the likelihood of natural disasters and the related costs of these events.
 - Use natural disaster clauses in debt contracts to link the country's repayment capacity to its risk exposure. These are key instruments in debt contracts, allowing countries to defer either interest or principal payments (or both) for a defined period.

Advance sustainable financial strategies to guide the transition

- Implement fiscal frameworks that protect green investment:
 - Develop tools, such as fiscal rules, that include green golden rules to protect green investment from economic and political cycles.
 - Apply green budgeting as an important tool for finance ministries and financial regulators to improve the alignment of national expenditure and revenue processes with climate and other environmental goals. These tools help evaluate the environmental impacts of budgetary and fiscal policies to achieve national and international environmental goals.
 - Channel public investment towards projects with greater environmental benefits by using lower Social Discount Rates (SDRs) to evaluate projects.
- Deliver the necessary support for NDBs and SDBs to enhance the mobilisation of public and private resources toward sustainable projects:
 - Optimise NDBs to help mobilise and leverage private flows towards low-carbon and climate-resilient pathways through de-risking and credit enhancement.
 - Back SDBs to help unlock and broaden local sources of funding and develop stronger subnational financial markets in the long-term, especially for intermediary cities.

Box 4.3. Key policy messages (cont.)

- Help further expand climate-related development finance to foster higher investments that guide green transition:
 - Support MDBs in structuring projects that attract more private lenders and offer the right protection mechanisms to borrowers.
 - Promote partnerships and co-ordination between MDBs and development agencies.
 - Tap into the growing resources of multilateral climate funds by developing greater capacity-building and project preparation skills as well as enhancing the use of the National Adaptation Plan (NAP) process.
- Advance the blended finance agenda. This requires continued collaboration between international and domestic development banks, as well as with policy makers and the private sector.
- Support the public sector in mobilising private sector resources:
 - Develop concrete regulatory reforms and enable market structures that improve participation of private actors while also increasing the role of competition and transparent pricing in the energy sector.
 - Further promote responsible banking mechanisms so that private banks reduce climate impacts through their business activities and redirect private flows towards a carbon-neutral scenario.
- Support the improvement and expansion of sustainable finance frameworks:
 - Expand regulatory tools (e.g. sustainability or green bond standards and green, sustainable or transition taxonomies) to increase the flow of private and public sustainable investments and avoid greenwashing.
 - Promote public-private co-operation to harmonise standards and taxonomies across the region to avoid inefficiencies for cross-border sustainable finance activities.
 - Support the broadening of sustainable finance frameworks in the non-banking sector (e.g. pensions, capital markets and asset management sectors) to boost competitiveness and investment opportunities.
 - Advance transition finance taxonomies alongside corporations in order to provide more capital to enable high-emitting activities to progressively shift or transition to lower emissions.

Notes

1. Following the Paris Agreement, to keep global warming to no more than 1.5°C, emissions need to be reduced by 45% by 2030 and reach net zero by 2050.
2. Argentina, Brazil, Colombia, Costa Rica, Ecuador, Guatemala, Mexico, Panama, Paraguay and Peru.
3. As of September 2022, there are 30 members of the DAC, including the European Union which acts as a full member of the committee. In addition, there are “Participants” and “Observers”. The listed Participants at this time are: Azerbaijan, Bulgaria, Kuwait, Qatar, Romania, Saudi Arabia and the United Arab Emirates. The Observers are: World Bank, the IMF, UNDP, the African Development Bank, the Asian Development Bank, and the Inter-American Development Bank.
4. The LAC Taxonomy Working Group is an initiative of the Interagency Technical Committee of the Forum of Ministers of Environment of Latin America and the Caribbean and is constituted by the United Nations Environment Programme, the ECLAC, the United Nations Development Programme, the World Bank Group, the IDB, CAF – Development Bank of Latin America and the Food and Agriculture Organization of the United Nations. The LAC Taxonomy Working Group is financially supported by the European Commission through the EUROCLIMA+ programme.

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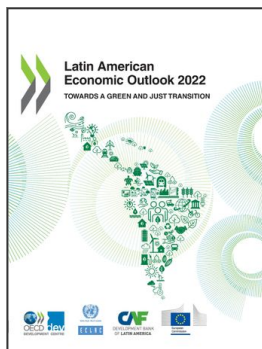
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