

# Innovative Financing for a Sustainable Future

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*Empowered lives.  
Resilient nations.*

This paper examines key issues surrounding innovative mechanisms for development and climate finance. It argues that much more potential exists to exploit such mechanisms in support of sustainable human development. In particular, policy makers have an invaluable opportunity at Rio +20 to advance political commitments and develop timetables for various initiatives. The paper examines why such mechanisms are urgently needed, and considers some major issues that need to be addressed. It concludes with a discussion of challenges and trade-offs.

## Background

The 2011 *Human Development Report, Sustainability and Equity: A Better Future for All*, makes a compelling case that the important increases in human development over the past 40 years will be reversed unless we urgently address issues of equity and sustainability. In order to attain more sustainable and equitable human development, international leaders need to change how production and growth are conceptualized. This requires immediate action paired with upfront finance on an unprecedented scale. Additional finance should be continuous, predictable and sustained to enable long-term planning and strategic action.

While the volume of resources required to meet the challenges of sustainable human development may seem bewildering and beyond reach, the costs of inaction are even greater further down the road. Simulations and scenario projections prepared for the 2011 *Human Development Report* suggested that by 2050, the global human development index (HDI) would be 8 percent lower than the baseline scenario under an 'environmental challenge' scenario that captures the adverse effects of global warming on agricultural production, access to clean water and improved sanitation, and pollution (it would be 12 percent lower in South Asia and Sub-Saharan Africa). Under an even more adverse 'environmental disaster' scenario, which envisions vast deforestation and land degradation, dramatic declines in biodiversity and accelerated extreme weather events, the global HDI would be some 15 percent below the projected baseline.<sup>1</sup>

Global and domestic financing to move to a lower carbon pathway should be prioritized, and simultaneously tapped by development finance practitioners. Waiting on new global finance mechanisms should not slow down adjustments, since domestic finance can already be catalysed nationally and locally by leaders committed to deep carbon cuts. In 2009, China set a goal of lowering carbon intensity by 40 to 45 percent from 2005 levels over the next decade. It later announced further short-term targets, and is supporting renewable energy through subsidies, targets and tax incentives. In 2010, India announced voluntary targeted reductions of 20 to 25 percent in carbon intensity.<sup>2</sup>

Developing countries now have more than half the global renewable power capacity. China leads the world in several indicators of market growth, including wind power capacity and biomass power, while India stands fifth in wind and is fast expanding such rural renewables as biogas and solar. Brazil produces much of the world's sugar-derived ethanol, and is adding new biomass and wind power plants.<sup>3</sup>

Increased funding is not only important for the environment, but also to expand local development capabilities, such as through social protection and health coverage. Setting a social protection floor, via transfers in cash and in kind, can achieve a great deal without being expensive. Conditional cash transfer programmes like Brazil's

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<sup>1</sup> UNDP 2011, p. 2.

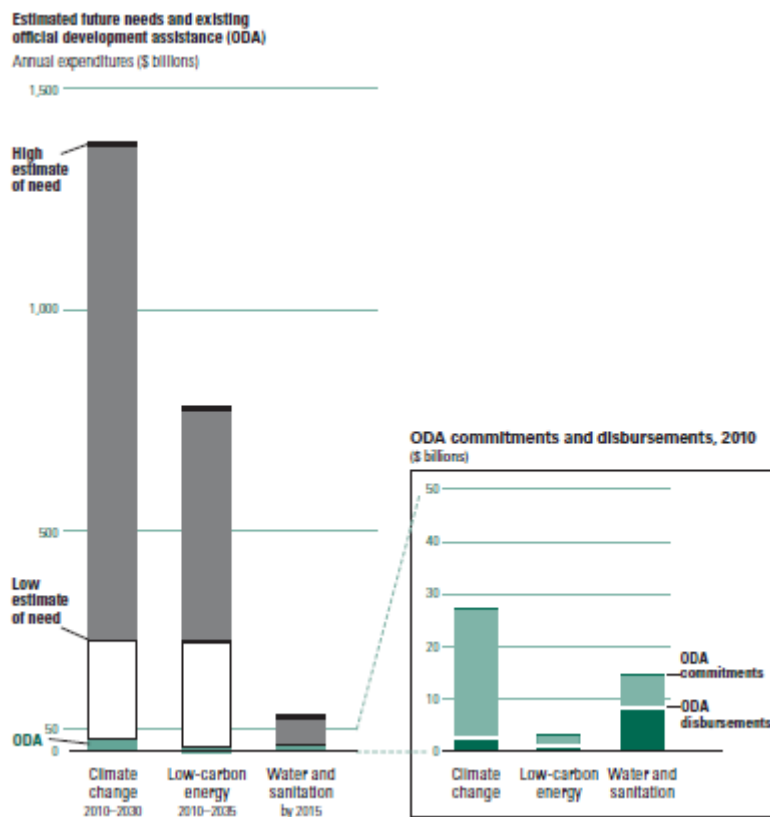
<sup>2</sup> Ibid., p. 70.

<sup>3</sup> Ibid., p. 69.

Bolsa Familia and Mexico’s Oportunidades cost their governments about 0.4 percent of gross domestic product (GDP) and provide coverage to about a fifth of their populations. India’s Mahatma Gandhi National Rural Employment Guarantee Act cost about 0.5 percent of GDP in 2009 and benefited 45 million households, about a tenth of the labour force. Low-income countries could also implement such schemes. The International Labour Organization (ILO) estimated in 2008 that a scheme guaranteeing workers 100 days of employment a year could cost less than 1 percent of GDP on average. In addition, the ILO estimated that less than 2 percent of global GDP would provide all the world’s poor with a minimum package of social benefits and services—defined as access to basic health care, education and income transfers.<sup>4</sup>

Finding new and innovative ways to sustainably fund human development is both essential and urgent. Official development assistance (ODA), while important, is unlikely to provide the sheer volume of finance needed for a truly comprehensive and integrated response (Figure 1). Moreover, it depends on donors’ current economic and financial situation. Being subject to cyclicity, it can potentially be disrupted without much warning. At a global level, the 2001 Report of the High-Level Panel on Financing for Development, chaired by President Ernesto Zedillo of Mexico, estimated conservatively that an additional US \$50 billion would be required annually to achieve only the current set of international development goals.<sup>5</sup>

**Figure 1: Official Development Assistance Falls Far Short of Needs**



Source: UNDP 2011, p. 93.

<sup>4</sup> Ibid., p. 94.

<sup>5</sup> Atkinson 2004, p. 6.

If the amounts needed are clearly large, however, they are below current spending on defense, recent financial sector bailouts and perverse subsidies, indicating the scope for reassessing priorities. In 2009, global military expenditure neared 3 percent of world GDP, while some countries spent much more, including the United States (4.7 percent of GDP) and the Russian Federation (4.3 percent of GDP).<sup>6</sup> The bailouts in the wake of the recent financial crisis were close to US \$700 billion in the United States under the Troubled Asset Relief Program, while EU commitments were close to US \$1 trillion (about 6 percent of annual GDP in both cases).<sup>7</sup> The International Energy Agency estimates that global fossil fuel subsidies exceed US \$500 billion per year.<sup>8</sup>

In this context, attention has turned to the potential of innovative sources of development and climate finance. Over the last decade, the international community has developed a range of so-called ‘innovative’ initiatives. These include the Clean Development Mechanism under the Kyoto Protocol, the international solidarity levy on airline tickets and the International Finance Facility for Immunisation, among several others. Such initiatives have produced important results.

They have so far been relatively small in scale, however, raising only an estimated US \$5.5 billion for the health sector and US \$31 billion for the environmental sector between 2002 and 2010. Much more potential exists for innovative financing mechanisms to pack a far greater punch and meet the urgent challenges ahead.

Some mechanisms demonstrate significant potential to become central components of a ‘new vision’ on financing for sustainable human development, since they provide a means to mobilize significant new sums that are not dependent on continuous donor contributions and that are sustainable over time. In the wake of the 2008 financial crisis, there is renewed interest in the potential of financial transaction taxes, for example. The 2011 *Human Development Report* advocates for the implementation of a coordinated currency transaction tax to finance sustainable human development, given the insufficiency of regular tax revenues. Carbon taxes and environmental fees also show potential for additional revenue collection and can help internalize externalities through the taxation of brown or environmentally unsustainable activities.<sup>9</sup> Other mechanisms include an expansion of air ticket levies, voluntary solidarity contributions, public private partnerships, branding of products, carbon emissions trading and the International Monetary Fund’s (IMF) Special Drawing Rights (SDR).

Options like these have the potential to transform the financing of international development and climate-related actions. Operating at both the global and local levels, they provide important opportunities for international coordination around shared challenges, for engaging the private sector, and for pooling private and public revenue streams. New technologies could play a role. The Internet, automatic payment systems and mobile phones have reduced revenue collection costs to close to zero, offering new avenues to mobilize resources from the private sector and citizens.

The real appeal and value of such approaches will only be leveraged if innovative finance initiatives are implemented well. The main challenge is to ensure that implementation goes to scale, and that the mechanisms are governed in an inclusive manner; allocate resources equitably and transparently among countries and ‘issues’ on the basis of clear and objective criteria; build capacity; complement each other; and respond flexibly

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<sup>6</sup> UNDP 2011, p. 92.

<sup>7</sup> Ibid.

<sup>8</sup> IEA et al. 2010.

<sup>9</sup> Australia introduced a carbon tax through the 2011 Clean Energy Act. Other countries, such as Norway, have already implemented these types of mechanisms.

to beneficiary countries' needs and priorities as expressed by them. Many countries—especially the poorest and smaller countries—will require sustained support to take full advantage of scaled-up external resources.

As interest has increased in innovative financing, the number of initiatives has multiplied. Many have established their own resource delivery channels, typically 'single issue' programmes. These focus on specific themes, such as a communicable disease or adaptation to climate change, and target resources exclusively at interventions to tackle that problem.

In practice, this has fragmented development finance architecture, which can best be described as a 'spaghetti bowl'. And while it has become increasingly clear that approaches to sustainable development must integrate economic, social and environmental concerns simultaneously, it is not clear that current approaches to innovative financing are able to accommodate this challenge. Instead, a competitive environment has emerged in which health and the environment have benefited most from recent financing initiatives, while other areas, such as agriculture and education, have struggled to attract attention. Inadequate coordination in development finance could result in missed opportunities to close gaps in economic and societal trends, such as rising global food prices, food insecurity (notably in Africa), or growing concerns about access to quality and affordable education (including in countries in the Organisation for Economic Co-operation and Development). Such trends may ultimately impact on social cohesion, and perceptions of inequality and justice.

As financing develops in the future, there is the potential for this architecture to become even more complex and difficult to navigate, especially in the area of climate finance. It will be vital to ensure that the spaghetti bowl effect is not exacerbated, since it entails significant transaction costs and inefficiencies that reduce the dollar value of the available resources. Finance and development are two unavoidably complex issues, but this should not undermine such fundamental objectives as accessibility to all actors, especially those who lack capacities. Some changes to the international development financing system—such as the Green Climate Fund—represent a step in the right direction.

Development strategies need to involve governments and people at a local level. Cities account for the majority of greenhouse gas emissions, requiring action by subnational governments, for example. This calls for coordinated planning and robust collaboration with a variety of traditional and new development actors, including national and regional technical centres of expertise, the private sector, communities and civil society organizations.

Fiscal space can be defined as “the financing that is available to government as a result of concrete policy actions for enhancing resource mobilisation, and the reforms necessary to secure the enabling governance, institutional and economic environments for these policy actions to be effective, for a specified set of development objectives.”<sup>10</sup> To widen fiscal space, domestic public resources can be mobilized by: enhancing tax revenues to increase public savings; raising public sector access to savings from households and firms for investment in public expenditures focused on Millennium Development Goal (MDG) attainment; and increasing the efficiency of public expenditures, notably by lowering the unit cost of providing public services without reducing their quality and quantity.

Additionally, resource mobilization needs to be pro-poor, with instruments chosen to minimize impacts on the disposable income of the poor (e.g., through progressive tax systems and domestic borrowing for public

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<sup>10</sup> Roy et al. 2009, p. 33.

investment).<sup>11</sup> The capital accumulation process generated by the Marshall Plan offers a compelling example of the importance of the dynamics between external assistance and domestic resource mobilization.<sup>12</sup> Thailand's progress both in MDG achievement and GDP growth is a case where resource mobilization and public investment resulted in crowding in (rather than crowding out) effects, which spurred the sustainable growth of the private sector.<sup>13</sup>

Looking forward, a coordinated mobilization of both global capital and local resources is essential to bring about the low-carbon economy envisioned for a more sustainable and equitable future. Domestic resource mobilization efforts complementing the capital accumulation process triggered by external assistance will be crucial.

## Key Issues for Consideration

When thinking about innovative finance, key issues for consideration are: additionality, potential for scale, sustainability, equity, local ownership and accessibility.

***Additionality:*** The scale of the resource gap is such that innovative sources of finance should aim to increase the resource envelope for international development and climate change adaptation and mitigation. Innovative initiatives should not substitute for traditional forms of development assistance; they should provide truly 'additional' finance. They should not replace, divert, crowd out or substitute for existing contributions. Tools to measure 'additionality' more accurately need to be developed.

***Potential for scale:*** Mechanisms that demonstrate considerable potential for scale may be especially attractive, given the volume of resources needed to meet global development and climate challenges. Approaches to development must integrate economic, social and environmental concerns simultaneously and coherently.

***Sustainability:*** Mechanisms should be able to raise funds on a sustainable and fairly predictable basis. They should not be contingent on donors' continuous contributions. Contributors should develop and coordinate strategies to ensure the counter-cyclicity of resource delivery, hence addressing a shortcoming of ODA. They should consider potential distortionary and incidence effects, as these may eventually generate opposing interests.

***Delivery mechanisms and local ownership:*** Funds should become part of national, regional and local development agendas to generate local ownership and increase recipient countries' fiscal space. Short-term or 'one-off' exercises, such as to raise resources for disaster relief, should also follow the principle of local ownership. Different schemes should complement each other. They should ensure that the capacities of targeted entities and populations develop alongside project delivery. This enhances efficiency at the local level, notably by widening fiscal space and empowering local actors. It may be useful to consider alternatives to vertical programmes when delivering new funds.

***Accessibility:*** Special action is needed to ensure that countries are aware of and able to take advantage of rapidly scaled-up finance, especially those that are poor, small and/or have limited human resources. Further work is needed to establish objective, transparent and operational criteria for the allocation of funds across countries and

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<sup>11</sup> Ibid., p. 23f.

<sup>12</sup> Ibid., p. 38.

<sup>13</sup> Ibid., p. 40.

sectors or issue areas. Innovative financing mechanisms should work as much as possible through existing organizational channels, and seek ways to manage the complexity of adding new actors to the development landscape.

## **Possible Options**

UNDP has advocated several new mechanisms to enhance innovative finance.

### ***Financial transactions taxes***

The 2011 *Human Development Report* advocates for the global implementation of a currency transaction tax as a financing mechanism for human development, the reduction of inequality and the achievement of sustainable natural resource use. This kind of tax is not a new idea, but the report argues that now is the time to push it forward. The report stresses that such a large-scale mechanism would help to fill current funding gaps, while enhancing the coherence of mechanisms for innovative finance.<sup>14</sup>

There has been some progress recently in these areas. For instance, France will levy a 0.1 percent tax on share trades to come into effect in August 2012. More countries, however, need to get on board to finance a global public good like sustainable human development across borders.

### ***Carbon taxes and environmental fees***

Australia has recently introduced a carbon tax set at AU\$23 per tonne of carbon released into the atmosphere; it is the second country to do so, after Norway.

The United Nations Rio +20 Conference on Sustainable Development provides an important opportunity to build political consensus and develop a concrete timetable for the implementation of large-scale, internationally coordinated innovative financing initiatives, such as a financial transaction tax and carbon taxes.

### ***Special Drawing Rights***

Using the IMF's SDRs for innovative financing and climate change adaptation is another avenue worth exploring. Monetizing part of the IMF's surplus could raise up to US \$75 billion at little or no budgetary cost for contributing governments. IMF analysis of the possible role of SDRs as seed finance for a new global green fund suggests that issuing additional SDRs and other reserve assets could mobilize US \$100 billion a year by 2020.

The SDRs have the added appeal of acting as a monetary rebalancing instrument; demand is expected to come from emerging market economies looking to diversify their reserve holdings. Because the SDR is not a sovereign currency, it would not be subject to the currency transaction tax, thus avoiding double taxation.<sup>15</sup> Whereas most innovative financing initiatives are pro-cyclical in nature, SDRs may be most appropriate as a countercyclical financing tool.

### ***Public and private resources***

Several public and private sources could also be tapped to close the financing gap. Already, innovative financing instruments—such as the Clean Technology Fund and the Strategic Climate Fund—are combining funding from

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<sup>14</sup> UNDP 2011, pp. 20, 94f.

<sup>15</sup> UNDP 2011, p. 96.

multilateral development banks, governments, climate finance instruments and the private sector. They have raised an additional US \$3.7 billion for development and can leverage substantial additional funds. Considerable private funding has also been leveraged.<sup>16</sup>

Public-private partnerships could be at the forefront of innovation in tackling current challenges. Aiming at market transformation, and applied to both climate mitigation and adaptation, they could contribute a great deal to facilitating the transition from a sunset to a sunrise economy. They could build on recent experience, but go beyond traditional service delivery and infrastructure to bring together the potentially diverging interests of a wide range of stakeholders, while blending various sources of finance. Public policies and measures underlying such partnerships will need to provide incentives to improve the risk and reward profile of specific investments with human development components, notably those consistent with national development goals.<sup>17</sup>

### **What Are the Main Trade-offs?**

Given the small-scale of many innovative financing initiatives to date, broader political momentum needs to be generated and sustained. Despite a generally strong response from civil society movements, however, governments have not yet acted in a large-scale, coordinated manner. The policy debate on innovative taxation is currently drifting away from development purposes. A ‘reasonable’ amount of the resources generated through innovative financing initiatives should be allocated to sustainable human development, instead of funding domestic priorities in contributing countries. More efficient strategies need to be developed to support more ambitious and internationally coordinated mechanisms.

A multistakeholder approach could substantially enhance donor coherence at the international, national and regional levels. Nevertheless, stakeholders should avoid increasing the complexity of fundraising and delivery mechanisms through the multiplication of small-scale and competing initiatives, which crowd each other out and lack strategic visibility. At the same time, principles of sustainability, transparency and local ownership would favour developing regions devising and implementing their own innovative financing. Given the recent proliferation of initiatives and programmes, stakeholders should ensure that an overall financing architecture emerges in a coherent manner and is able to guide the delivery of resources in the most accessible, targeted, efficient and effective ways.

The magnitude of the challenges ahead requires a simultaneous response to economic, social and environmental concerns. Increasing the fiscal space of countries receiving financing could be a way to achieve greater coherency and local ownership. Innovative financing mechanisms must also avoid punishing populations who live under less accountable governments.

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<sup>16</sup> UNDP 2011, p. 96.

<sup>17</sup> UNDP 2011, p. 97.



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