The Rationale for Innovative Finance for International Climate Finance

What is ‘Innovative Finance’?
In the context of international climate finance for developing countries, the term ‘innovative finance’ refers to (off-budget) earmarked public sector sources, usually but not always related to combatting climate change, such as:

- Auctioning of emission permits in emission trading schemes (the focus of this memo)
- Carbon or other taxes
- Two-percent share of proceeds from the Clean Development Mechanism (CDM)

Provider Perspective
While treasuries often regard earmarking of public revenue sources as problematic, it is nonetheless widely practiced (for example in the context of national lotteries). Earmarking for international climate finance is much less problematic if it is from a source that is already earmarked, as is often the case for emission auction proceeds when used to fund domestic climate action.

Earmarked sources are usually treated as being ‘off budget’ and, as such, are generally more predictable/automatic than budget allocations, which helps with planning of longer-term activities.

For reasons explained below, developing countries have been adamant ever since the adoption of the 2 percent adaptation levy on CDM proceeds – which indeed was their quid pro quo for consenting to establishing the CDM in the first place – that any other flexibility mechanism should have such a development component.

Using a small share (2% is the historic UNFCCC benchmark) of the auction proceeds for international climate finance would hence pave the way to making an integration of subnational emission trading schemes into a new international trading mechanism more palatable for developing countries.

In the case of Quebec, it would also have the added advantage of strengthening its international ties with the poorest and most vulnerable countries, many of which being part of the Francophonie.

Last but not least, it would also be a pioneering shift to a new paradigm in the modality of multilateral finance, to be emulated by other governments in due course.

The Recipient Perspective
Economically, the rational for receiving innovative finance is the same as it is in developed countries, i.e. predictability/automaticity, only more so: domestically, it is possible for recipients of budgetary resources to influence budget allocations through democratic processes and/or lobbying. Developing country recipients of international budgetary contributions do not have this option.