

# Key findings



## Aligning Policy-Based Finance with the Paris Agreement: Potential to Bolster Cooperation with Governments and PDBs

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*“on behalf of Germanwatch and NewClimate Institute”*



This overview is published in the framework of the third edition of the Finance in Common Summit in Abidjan “Green and Just transition for a sustainable recovery”.

The Glasgow Climate Pact calls upon multilateral development banks (MDBs) to accelerate their alignment with the Paris Agreement, but an approach for policy-based operations (PBOs) has not yet been determined. PBOs support macro-fiscal stability and development plans by financing government budgets—mostly as sovereign loans—in exchange for policy and institutional reforms, or “policy actions”. We define Paris alignment in PBOs as whether their policy actions and budget support undermine or promote long-term macro-fiscal stability and a just transition to climate neutrality by 2050. We reviewed bank policies and evaluations, interviewed 29 bank staff, analyzed a representative sample of PBOs in three policy areas, and examined six case studies to formulate our recommendations.

Aligning PBOs with the Paris Agreement requires MDBs and their shareholders to enhance the provision of budget support for reforms that promote a just transition to climate neutrality. MDBs need to systematically inform policy actions with longer-term climate considerations and create guidance to screen potential for significant harm to Paris alignment. Shareholders can, through a multi-donor trust fund, use grants and guarantees to co-finance MDB budget support for policy actions that contribute to the provision of global public goods. MDBs and shareholders can also bolster the coordination which occurs in formulating PBOs to align reforms and investments with the Paris Agreement, including contributing to these objectives with other public development banks (PDBs) in country.



### Objectives and research questions

This paper aims to support MDBs and government shareholders to align policy-based finance with the Paris Agreement. It explores three research questions:

1. How should Paris alignment be defined in policy-based operations?
2. How should MDBs operationalize the “do no significant harm” principle in policy actions?
3. What is the potential of policy-based operations to support governments with climate action, and other stakeholders make full use of its transformative benefits?



## Methods

We propose a framework for formulating and implementing Paris-aligned PBOs based on a review of MDB policies, evaluations, and program documents. To improve our understanding of the potential for policy actions to do harm to, as well as support, climate action, we analyzed a representative sample of 126 operations from a total of 361 PBOs in 2018-20 in three policy areas: public finance management, public sector management, and energy. We applied findings from this analysis to six case studies to identify gaps in Paris alignment as defined in our framework and interviewed bank staff to understand challenges and test our proposed approach.



## Results

Recognizing that the amount and terms of budget support can influence formulation, we propose defining a PBO as Paris-aligned if its policy actions do not increase macroeconomic, fiscal, or social exposure to climate risks and, wherever possible, support long-term resilience and a just transition to climate neutrality.

Using this definition, we screened policy actions by MDB staff, and found that current practice does not prevent potential harm to governments' ability to implement or enhance ambition in their NDCs and achieve climate neutrality. Policy actions can create macro-fiscal path dependence in climate vulnerable activities (e.g., agriculture, fossil fuels) and delay urgent climate expenditures that would decrease overall transition costs. We also find that most PBOs, certainly all that aim to support longer-term macro-fiscal stability, can simultaneously support countries' development objectives and Paris alignment.



## Recommendations

1. **Shareholders** should establish a multi-donor trust fund to co-finance MDB budget support for policy actions that contribute to global public goods, using grants and guarantees.
2. **MDBs and shareholders** should bolster the coordination which occurs in PBOs to align reforms and investments with the Paris Agreement, including jointly contributing to these objectives with other public development banks operating in country.
3. **Country governments** need to start requesting this type of funding to support a just transition to climate neutrality in their policies.
  - a. This requires bank and shareholder support for considering climate policies in support of mitigation and adaptation as an integral step towards macro-fiscal resilience.