

POLICY BRIEF



Unleashing Green Investment Incentives for Climate Transition

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Álvaro Ons, Centro de Investigaciones Económicas (CINVE) and South American Network on Applied Economics (Red Sur) (Uruguay)
Andrés López, Instituto Interdisciplinario de Economía Política de Buenos Aires (IIEP UBA CONICET) and South American Network on Applied Economics (Red Sur) (Argentina)
Cecilia Alemany, UN Women Regional Office for the Americas and the Caribbean, PhD Candidate at the Complutense University of Madrid (Uruguay)
Patricia Alemany, Complutense University of Madrid (Spain)



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Trade and
Investment

Abstract

Latin America's investment incentives landscape, characterised by generous but loosely targeted programmes, presents a unique opportunity for a strategic redesign whose objectives and features may be relevant for other developing countries and regions.

This policy brief, based on previous in-depth research carried out in several Latin American and Caribbean (LAC) countries, explores how revamped investment incentives can propel developing countries towards climate-resilient, carbon-neutral economies, even amid fiscal constraints.

Instead of simply layering green requirements onto existing programmes, this Policy Brief advocates for a deep dive, assessing each incentive's relevance, effectiveness, and fiscal impact. This paves the way for streamlining, termination, or transformation of existing incentives, while at the same time introducing new incentive instruments tailored to climate challenges.

While country-specific nuances exist, based on the LAC experience, a nearly universal toolkit for reform emerges under the Sustainable Development Goals (SDGs) and the Paris Agreement objectives. This Policy Brief provides evidence and practical recommendations for the South African G20 Presidency to encourage a paradigm shift and accelerate implementation of green investment incentives through:

- Targeted incentives: focus on projects demonstrably aligned with climate goals, maximising impact while minimising the use of public funds.
- Performance-based rewards: link incentives to verifiable emission reductions or adaptation measures, ensuring tangible progress in climate transition.
- Aligning green investment incentives with goals related to productive development strategies and the promotion of domestic innovation activities.

Institutional muscle is paramount. Redesigning investment incentives demands robust policymaking and implementation capabilities. This demands coordination across government agencies and a culture of flexibility, enabling swift adaptation to evolving needs. Also, green investment incentives need to converge in the same direction as other governmental policies in a long-term view. This is feasible even in the context of fiscal restrictions, since the greater targeting of the instruments is consistent with their rationalisation, ie, there is greater effectiveness in terms of SDGs together with a reduced impact on public finances.

Keywords: Investment Incentives, Tax Incentives, Green Incentives, Latin America and the Caribbean, Green Industrial Policy

Diagnosis

Investment incentives in Latin America and the Caribbean (LAC) are characterised by generous but loosely targeted programmes, dominated by tax incentives and with an extensive use of tax holidays.¹ This description applies also to several low and middle-income countries in other regions. These starting conditions open the opportunity for significant redesigned investment incentives systems, aimed at contributing to the transition to climate-resilient, carbon-neutral economies. This is feasible even in the context of fiscal restrictions, since the greater targeting of the instruments is consistent with their rationalisation, ie, there is greater effectiveness in terms of development goals together with a reduced impact on public finances.

The overwhelming predominance of tax incentives in current investment promotion programmes, coupled with budget restrictions, indicates that this prevalence will remain, since tax incentives imply a fiscal waiver rather than an outflow and, as long as they are not redundant, they do not imply a fiscal cost in the future.² However, the current implementation of green incentives shows a heavy presence of non-refundable support and grants, suggesting the relevance of considering the potential effectiveness of different kinds of incentives.

The opportunity and the need for the reformulation of investment incentives from a climate transition perspective comes at a time when, to a greater or lesser extent depending on each national case, there are some additional reasons why a comprehensive review of these instruments is necessary:

¹ Tax holidays: full or partial Corporate Income Tax (CIT) exemptions.

² A redundant incentive is one that does not affect the investment decision, as the investment would have been made even in the absence of the incentive. If the incentive is not redundant, the fiscal waiver does not imply a fiscal cost attributable to the application of the incentive because there would be no revenue to waive in the absence of the incentive.

1. Investment incentive programmes usually fail to reflect in their design and implementation some of the widely accepted best practices, such as implementing monitoring and assessment activities, establishing requirements and offsets to promote development goals, and making benefits time-bound, among others. A widespread improvement in the quality of the instruments is a necessary condition for improved management of more sophisticated incentives such as green incentives.
2. Since investment incentive programmes are dominated by tax incentives and include extensive use of tax holidays, their effectiveness may be affected to some extent by the global tax reform of the Inclusive Framework on Base Erosion and Profit Shifting (BEPS), in particular, with the establishment of a minimum effective tax rate on corporate income (Pillar 2).³
3. There are relatively frequent cases of very long-standing promotional schemes that have not been updated, and there has been no assessment of the wisdom of their continuity or the requirements and conditions for their continuity. There are several widely used schemes whose characteristics point to significant levels of redundancy.
4. The post-pandemic international context has accelerated the trend towards the regionalisation of global value chains given the concern of governments and multinational companies over their vulnerability, with the resulting new opportunities to attract investment and/or expand exports.
5. Apart from the commitments resulting from the national climate change mitigation and adaptation strategies, the adjustment of the investment incentives may be motivated by compliance with environmental requirements in the target markets of exports or the requirements for access to funding in terms of sustainable finance.

³ Under certain conditions, the application of the GloBE Rules of Pillar 2/BEPS 2.0 may determine that all or part of the Corporate Income Tax exempted to a multinational company as a result of an investment incentive must be paid in another jurisdiction, eliminating or reducing the potential effect of the incentive on investment decisions.

The reformulation of incentives should not be limited to building offsets or green requirements into existing programmes. A profound redesign should be undertaken based on the assessment of relevance, opportunity and conditions for their continuity, reform or termination, and the possible introduction of new instruments. It is also necessary to consider alternative uses of the resources allocated to incentives, both as part of investment promotion objectives as well as in terms of the national environmental strategy.

Recommendations

Brazil's G20 presidency in 2024 highlighted the need for an international investment policy environment that catalyses sustainable development. The G20 is a key forum for discussions about principles and implications of a redesign of investment incentives geared to climate transition, in particular, from the perspective of developing countries that rely heavily on tax incentives. In this sense, although the redesign of the investment incentive system will depend on the specific situation in each country, it is possible to advance some inputs for future discussions through the identification of a range of possible programme contents that will help to define a reformulated system geared to climate transition:

- 1) Investment incentives, both general and sectoral in scope, with requirements in terms of energy efficiency, reduction of greenhouse gas emissions or climate change adaptation which must be met by machinery and equipment, industrial plants, buildings and other facilities involved, essentially aimed at the acquisition, construction, replacement or reconversion of existing equipment and facilities.
- 2) Incentive programmes for investment in activities that are the main national sources of emissions for the purpose of incorporating technologies and behaviours that will contribute to reducing such emissions. These are often major productive activities for the respective national economies whose continuity and

possible expansion are necessary but with significant reductions of their environmental impacts, and in line with the goals of the national environmental development strategies. They typically involve certain agricultural, industrial and transport and logistics subsectors.

3) Incentive programmes for investment in: i) the production of electricity from renewable sources; ii) biofuel production; iii) carbon capture and storage projects; iv) low-emission, high-productivity activities, and activities in clean technology chains (including the production or assembly of specific components),⁴ v) efficient solid waste management and circular economy and waste recovery mechanisms.

4) Incentive programmes that provide support for business partnerships as a mechanism to enable investments in climate change mitigation and adaptation which are beyond the capabilities of individual companies but can be achieved through the cooperation of producers in the same line of business and/or region. Examples of the above are irrigation systems, power plants to produce electricity from renewable sources for self-consumption and other infrastructure that can be shared and requires a modest scale. The concept also applies to issues such as sectoral statistical information systems and joint research and innovation projects.

5) Incentives for R&D spending on technological innovations in products and/or processes that will contribute to climate change mitigation and adaptation and sustainable development. Several developing countries are implementing horizontal tax credits for a percentage of R&D expenditure, which could incorporate some kind of preference for environmental issues. In turn, some countries have research and innovation agencies that implement subsidy programmes for R&D activities, in which sectoral prioritisation is usual.

⁴ For instance, some countries in LAC have been successful in promoting business services exports, a low-emissions activity that may generate significant productivity gains and knowledge spillovers. Furthermore, since tourism is a significant sector in several developing countries, investment incentive programs may open opportunities to expand sustainable tourism combined with the conservation of natural and historical heritage resources.

The suggested guidelines assume that investment incentives conditioned by specific offsets and requirements can potentially contribute to climate transition by influencing the technologies used, the sectoral structure of production, and certain producer behaviours. The effectiveness of green requirements and offsets depends on their being a necessary condition for access to benefits⁵ and in avoiding programmes that may have some kind of green component but allow substantive benefits without satisfying that component.

Poorly designed adaptation strategies are often the drivers of maladaptation (Schipper, 2020). There are growing concerns on how existing adaptation and mitigation strategies can increase vulnerability of certain groups, communities or populations (eg, limiting markets' access to SMEs or rural cooperatives or increasing care burden on women, Alemany et al, 2024). To promote a just transition, green incentives should consider social and ecological knowledge of the local context, of the affected value chain or sector (Schipper, 2020).

The redesign of investment incentives aimed at promoting climate transition implies a departure from one of the basic criteria of traditional incentive systems, namely, the bias towards the promotion of greenfield investment projects or those that determine a significant increase in the production capacity of companies in operation. To the extent that conversion to technologies that reduce greenhouse gas emissions is also desirable, the expansion of production capacity is not a necessary condition, and an incentive that promotes the replacement of machinery and equipment, the reform and adaptation of facilities, the change of energy supply sources or the replacement or reuse of inputs or raw materials is well-founded as long as the upgrade leads to reduced emissions or greater capacity to adapt to climate change and advance a just green transition.

⁵ As a general rule, exceptions may apply. For instance, it would be unreasonable to condition any benefit to R&D expenditure on its orientation to environmental matters (but it would be reasonable in the case of energy efficiency standards in the acquisition of machinery and equipment).

The practical consequence of redesigning current incentive programmes with a broad sectoral scope and no environmental requirements, as is the case in several developing countries, is not so much that incentives will be given to projects that contribute to climate transition but that they will no longer be given to projects that do not (López and Ons, 2023). The reformulation of investment incentives therefore implies withdrawing benefits or making access to them more expensive as part of a prioritisation of sectors, activities or behaviours. These issues can motivate lobbies and require a high degree of legitimacy and priority of climate transition on government agendas as a condition for aligning public and private stakeholders and securing medium- and long-term commitments.

Some of the above points refer directly to the features or requirements of the institutional arrangement, that is, political and organisational stability, prioritisation on the government agenda and integration between productive development and environmental policies. Institutional aspects are key pillars of sustainable productive transformation and, more broadly, of the climate and social transition process. The reformulation of investment incentives for a climate just transition calls for significantly improved public policy design processes and the building of implementation and evaluation capacities which are not required for current incentive programmes with relatively limited targeting. Therefore, capacity building in both the public and private sectors must be a component of the sophistication of investment promotion instruments aimed at sustainable productive transformation. No significant progress can be expected in situations with sub-optimal policies, even if they are consistent with the limited existing capacities.

Finally, although the transition to the new set of policies and incentives will be determined by the features of each of the countries, it is advisable to identify opportunities for regional cooperation, based on problems that may be common

to several of them. For instance, the treatment of underdeveloped and socially significant agricultural subsectors or institutional capacity building in public and private sectors.

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For publication enquiries, please contact t20@t20southafrica.org

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