HOW TAX CARROTS AND TAX STICKS CAN TRANSFORM THE WILD ECONOMY INTO A CLIC ECONOMY

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The Club of Rome[i] is a group of scientists, educators, economists, humanists, industrialists, and civil servants founded in 1968 by the successful Italian industrialist and philanthropist Aurelio Peccei when the world's population was around 3.5 billion. In 1970 the Club of Rome tasked a group of scientists to undertake a study to define the physical limits to population growth and the constraints resulting from economic activities on the planet. In 1971 the findings of their studies in a report called 'the limits to growth'[ii] were presented at international gatherings in Ottawa, Moscow and Rio de Janeiro. Their report had 3 main conclusions:

1. If the present growth trends in population, industrialisation, pollution, food production, and resource depletion continue unchanged, the limits to growth on this planet will be reached sometime within the next one hundred years. The most probable result will be a rather sudden and uncontrollable decline in both population and industrial capacity.
2. It is possible to alter these growth trends and to establish a condition of ecological and economic stability that is sustainable far into the future. The state of global equilibrium could be designed so that the basic material needs of each person on earth are satisfied and each person has an equal opportunity to realise his individual human potential.
3. If the world's people decide to strive for this second outcome rather than the first, the sooner they begin working to attain it, the greater will be their chances of success.

Needless to say the world was shocked following the publication of this report and the general consensus at the time was that urgent action was needed to alter the trends. Fast forward more than 50 years and the world's population is around 8 billion whilst the world's economy is still based on a flawed system that is predominantly WILD (Wasteful, Idle, Lopsided and Dirty). Non-governmental organizations (NGOs), Governments, Policymakers and Public Interest Groups have time and again called upon businesses and consumers to change their behavior aimed at converting the WILD economy into a CLIC ® (Circular, Lean, Inclusive and Clean) economy. [iii]

Not until 2015 serious traction was achieved when the so called Paris Climate Accords covering climate change mitigation, adaption and finance as well as the Sustainable Development Goals were agreed upon. As a result Governments around the world have been using their legislative and regulatory toolkit to address climate change and force businesses in general and Multi National Enterprises (MNEs) in particular to become more sustainable and responsible around their obligations towards society and the world in which they operate.

A key instrument available to Governments, in addition to green policy and regulatory measures, is green tax policy aimed at use of revenue-generating, revenue-spending and revenue-neutral fiscal instruments for improving the sustainability aspects of doing business. This article discusses the various levies (the tax sticks) and incentives (the tax carrots) that Governments are deploying as part of their green tax policy and how MNEs are responding to and addressing these policy measures.

THE DIFFERENCE BETWEEN SUSTAINABILITY AND ESG

Although sustainability and Environmental, Social and Environment (ESG) are often times considered similar there is one fundamental difference. Sustainability is an umbrella term which could mean different things for different businesses whereas ESG is specific and measurable. The Environmental dimension includes areas like reducing carbon emissions, improving resource efficiency, reducing waste and complying with environmental regulations.
The Social dimension focuses on employees, customers, communities and includes workplace safety, employee engagement, diversity and inclusion, customer satisfaction and data privacy.
The Governance dimension addresses business leadership and structure and includes executive remuneration,

shareholders rights, how audits are conducted and preventing bribery, corruption and money laundering.

GOVERNMENT ACTIONS

Governments around the world are using tax measures to adjust market failures, to try and reduce emissions, meet their commitments on carbon neutrality and tackle climate change, as well as to raise revenue and fund important policy objectives. While these goals are shared, the policies established to achieve them vary greatly.
Historically there have been twin tax policy approaches to driving transformation change in business and consumer behavior addressing the environment impact using either tax sticks or tax carrots. The European Union (EU) had traditionally lead and focused on tax sticks whereas the United States of America (US) had primarily focused on tax carrots.[vi] Since 2016 a third policy approach to drive transformational change for businesses addressing their social and governance impact has been adopted which is public disclosures in the form of providing tax transparency (tax profiling).

The current economic climate with a global Covid-19 pandemic potentially past its peak presents opportunities for both governments and businesses to achieve a 'deep green' recovery that provides dual benefits of both increasing investment spent as well as decreasing environmental damage. Supplementing environmental policy and regulations, fiscal instruments in the form of tax carrots and tax sticks can help address price issues and are likely to offer the most effective measures to achieve meaningful change.

TAX STICKS

A whole range of tax levies exist in many countries around the world aimed at reducing the carbon footprint of doing business and stimulating circular business models. They are mostly in the form of carbon emission taxes and environmental resource based taxes such as fuel taxes, energy taxes, waste taxes and plastic taxes. Sometimes the taxes are levied on a national/federal level and sometimes on a local/state/municipal level.

Whichever taxing mechanism is being used there may be the risk of high carbon prices and environmental taxes being regressive as they are ultimately passed on by businesses to end consumers. As a result, their impact is felt disproportionally by poorer members of society especially if the tax falls on heating fuels, housing and transport.

For instance, the French president Emmanuel Macron sought to increase fuel taxes in 2018 to target carbon emissions by raising petrol and diesel taxes. This tax reform was complemented by reducing wealth taxes mainly for the rich and this resulted in violent riots throughout Paris and other parts of France by the so called 'yellow vest' movement. As a result, the French government decided to bow to the protesters and the planned tax hikes were suspended proclaiming that 'no tax deserves to endanger the unity of the nation'.[vii]

There is also the risk of increased production in, or sourcing of high emission products from, a second country with less strict climate policies (so called "carbon leakage") meaning that tax sticks could possibly even have a net negative effect on the overall carbon emissions. To address carbon leakage in the EU, a Carbon Border Adjustment Mechanism is considered which will be a charge on imports of iron, steel, aluminum, fertilizer, cement and electricity based on the price of EU Emissions Trading System.[viii] This raises concerns however about protectionism and negative impact on world trade. The general consensus is that global cooperation would be better and should be in the form of a global carbon pricing mechanism. Unity and cooperation must be striven for, acknowledging that different countries are at different stages of the journey to curtail greenhouse gas emissions and use different tools. The inconvenient truth is that time is running out whilst unity is difficult to achieve given nationalism, protection of national interests and the political necessity to preserve economic competitiveness, especially those of the superpowers in the world such as the EU, the US and China.

In the Dutch Caribbean there are currently no tax sticks used as a policy instrument by the Governments of Aruba, Curaçao and St Maarten. They are currently not considered which I assume is because its impact would be felt disproportionally by poorer members of their societies.

TAX CARROTS

There are thousands of different sort of 'green' tax incentives available to businesses around the world varying from sustainability grants and incentives to tax exemptions. The main incentives are centered around decarbonizing the world's economy (reduction goal), expanding and using existing technology (switch goal) and creating new technology around renewable forms of energy solutions mainly solar, wind and water (innovate goal).
Most grants and incentives reduce the costs of doing business by focusing on (partial) project cost reimbursement, tax rate discounts or tax deduction for amounts investment in – inter alia- energy efficient buildings & processes, production and use of hydrogen-based fuels, renewable energy solutions, recycling of materials, green R&D initiatives, carbon capture technologies, and limiting the uses of plastics and packaging. Tax exemptions for businesses could for example come in the form of exemptions from environmental taxes based on achieved emission, water and waste use reductions, or in the form of corporate tax exemptions relating to the production or use of renewable energy solutions.

Some very successful and transformative businesses would not even have survived or existed without these tax incentives. For instance, Tesla is essentially a massively loss making company were it not for the emission credits it is selling to other car manufacturers coupled with the tax credits and subsidies its customers are receiving when buying and driving their electric vehicles.[x]

In the Dutch Caribbean there are currently no such tax carrots used as a policy instrument by the Governments of Aruba, Curacao and St Maarten and they are currently not considered. In order to maintain their international competitiveness and demonstrate that sustainability is taken seriously by the respective Governments and business initiatives to reduce their carbon footprints are being encouraged and sponsored it would be welcomed if tax carrots are to become part of their tax policies.

TAX PROFILING

The call for public tax transparency by mainly MNEs comes from a mistrust by some stakeholders resulting from the perception that businesses misuse the international corporate tax system to avoid paying their 'fair share' of tax. Some businesses have already responded with greater public tax transparency to demonstrate that their approach to tax is sustainable and responsible. Tax transparency may take different forms with disclosures of information that is quantitative, qualitative or sometimes both.

Quantitative disclosures provide details of how much tax was paid during a certain time period and where such taxes where paid. Often, additional information is provided such as how many employees were employed in a certain jurisdiction as well as what the revenue and profit before taxation was in the jurisdictions where there is taxable presence. For many MNEs this information is already available because this needs to be provided to the tax authorities in the jurisdiction where the Company is headquartered under the so called Country-by-Country Reporting (CbCR) obligations. CbCR is solely aimed however at corporate taxation assisting tax administrations to determine if related parties within an MNE are dealing with each other on an arm's length basis – i.e. that there is no artificial profit shifting and tax base erosion taking place.

Qualitative disclosures describe a company's approach to tax. Some MNEs have already made their board approved tax strategy or tax policy publicly available. For large companies and groups operating in the UK this is even a legal requirement since 2016. In Poland legislation is in force since 2021 requiring companies with Polish revenues in excess of EUR 50 million to publish a progress report including both quantitative and qualitative tax information. There are various other countries such as Australia, Denmark, the Netherlands and Spain where such disclosures are strongly encouraged and are aimed at building trust between corporate taxpayers and tax administrations.

Increasingly, businesses are not only disclosing on a voluntary basis corporate tax payments but also payment information for other kinds of taxes which are being borne and which are being collected on behalf of the government by doing business in a country. This is mainly driven by public pressure from consumers, NGOs and tax transparency advocates. Such disclosures usually take the form of a tax contribution report which is made publicly available through corporate websites. Where businesses are voluntarily disclosing tax information they are encouraged to report in accordance with recognized tax transparency standards such as the Global Reporting Initiative's tax standard (GRI 207) as issued by the Global Sustainability Standards Board which are applicable as from 2021 for companies that have elected to endorse GRI Standards and identified tax as a material topic to disclose its management approach to tax as well as their CbCR. Examples of such reports are those of the Swedish based Fortum Group and the (now) UK based Shell Group.

Businesses should expect additional government actions on enhanced tax reporting in the near future. For instance political consensus was achieved within the EU on a public CbCR Directive which was published in December 2021. This Directive must be codified by the EU Member States in their domestic legislation and will require both EU headquartered MNEs and non EU headquartered MNEs (with large subsidiaries in the EU) with global revenues of at least EUR 750 million for two consecutive years to publicly disclose their corporate tax payments on a country-by-country basis for all jurisdictions within the EU and jurisdictions found on the EU list of uncooperative jurisdictions (the so called EU tax haven blacklist). In the meantime in the US the US House of Representatives has recently passed the Tax Havens and Offshoring Act requiring corporations registered with the US Securities and Exchange Commission to publicly disclose CbCR information. Although the adoption and implementation date of these new public tax reporting obligations has stalled somewhat it is expected they will become a reality for businesses rather sooner than later. The practical relevance of enhanced tax reporting in the Dutch Caribbean is likely to be limited given the limited number of local headquartered MNEs which would fall within the scope of such regulations.

HOW BUSINESS IS RESPONDING

Most MNEs are evaluating their business strategies, their investment profiles as well as their risk and business operating model in response to – inter alia - the various ESG related tax measures. In addition, to finance their transition toward a greener future they are identifying and applying for tax credits, grants & incentives and funding's that they are eligible to.

Environmental taxes are usually not on the priority business radar but an increasing number of taxes and resulting tax audits potentially giving rise to interest and penalties in case of non-compliance demands that businesses have access to the required data and ensure that proper reporting is in place requiring high quality data, clear processes and controls.

The increasing importance of environmental taxes, carbon pricing and their impact on the price of the product and margin will likely transform the tax function within an MNE to be a key player of the ESG strategy, value chain and business model discussion.

As governments, consumers, investors, employees, and society at large are demanding transparency from businesses on how they address ESG issues and policies, their tax transparency reporting and strategy continues to evolve. Businesses are therefore re-defining their approach to tax transparency and coordinate it with their broader sustainability strategy. This means that more comprehensive and detailed standards are being developed. More tax information needs to be provided and be made available to assess the value impact and investment proposition from an economic, environmental and sustainability perspective. One of the most important considerations in determining tax transparency are the cost and efforts to produce reliable data and define the strategy and approach to tax. All MNEs that have had to prepare and submit CbCR filings have learned that the extraction and aggregation of tax data and ensuring completeness, accuracy and consistency of this data across often times multiple ERP systems is a significant undertaking. Some MNEs are likely to consider an assurance process to validate the data integrity before using this in publicly available tax transparency reports. With a solid tax strategy and supporting governance and control framework the larger MNEs are usually well positioned to obtain and provide reliable data and determine the degree of tax transparency that is right for them. Smaller MNEs – especially those that currently do not prepare and provide CbCRs and do not have a tax strategy and operational tax risk control framework- are likely to struggle.

CONCLUSIONS

Public revenue streams can effectively counter undesirable market outcomes. Governments around the world are increasingly using tax policy to drive transformational change of the WILD economy into a CLIC economy. The main green tax policy tools addressing the environmental impact of doing business are tax sticks in the form of carbon emission taxes and environmental taxes and tax carrots in the form of sustainability incentives and environment tax exemptions. A relatively new tax policy instrument in their toolbox addressing the social and governance impact of doing business is tax profiling which takes the form of both qualitative and quantitative disclosures. All these fiscal instruments contribute to price correction and redirecting consumers, investment and finance to sustainable initiatives, forcing businesses in general and MNEs in particular to evaluate their business strategy as well as their approach to tax. There are currently no tax sticks, tax carrots and tax profiling obligations in the tax policies of the Dutch Caribbean Governments. Reliable data and solid governance and control frameworks are required to comply with the various tax obligations and safeguard their tax effectiveness. It is hoped that the various ESG related tax measures and initiatives will help prevent the rather sudden and uncontrollable decline in both population and industrial capacity within the next 50 years as predicted by the Club of Rome and that tax can truly save the world.

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[i] https://www.clubofrome.org/
[ii] https://www.donellameadows.org/wp-content/userfiles/Limits-to-Growth-digital-scan-version.pdf
[iii] https://www.sfi.ch/en/about-us/news/transitioning-from-a-wild-to-a-clic-economy
[iv] https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement
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[vii] https://www.kazu.org/2018-12-04/france-freezes-fuel-tax-hike-in-face-of-yellow-vest-protests
[viii] https://www.consilium.europa.eu/en/press/press-releases/2022/03/15/carbon-border-adjustment-mechanism-cbam-council-agrees-its-negotiating-mandate/#:~:text=The%20Commission%20presented%20its%20proposal,than%20those%20of%20the%20EU).
[ix] https://oxfordtax.sbs.ox.ac.uk/article/how-and-why-a-global-carbon-tax-could-revolutionize-international-climate-change-law
[x] https://edition.cnn.com/2021/01/31/investing/tesla-profitability/index.html