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PLATFORM FOR TAX GOOD GOVERNANCE

Sustainable Finance and Tax

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Introduction

The purpose of this discussion paper is to follow up on the topic of tax and Corporate Social Responsibility (CSR), which was the subject of an initial discussion in the March meeting of the Platform on Tax Good Governance. The Commission paper sparked an interesting first debate, and a number of important initiatives were highlighted, based on contributions from NGOs, business, and the Commission. A clear conclusion from the discussion was that tax policy is becoming increasingly mainstream as an important element of Environmental, Social, and Governance (ESG) criteria. For the purposes of this follow up we would like to introduce the sustainable finance angle of this debate. Sustainable Finance is an important, and topical, aspect of CSR, perhaps even more so after the long awaited preliminary political agreement on public country-by-country reporting of multinationals[1] and in light of the recent G7 Finance Ministers' Communique of 5 June 2021 which called for moving towards mandatory climate related financial disclosures[2]. The increased transparency of both these measures will further increase public awareness of these issues.

What is sustainable finance?

Sustainable finance in its broader context, refers to the process of taking environmental, social and governance (known as ESG) considerations into account when making investment decisions. The idea behind this approach being that it will lead to more long-term investment in sustainable economic activities and projects. Recently, ESG investing has grown in importance as suggested by its "interest over time" which is tracked by Google Trends:

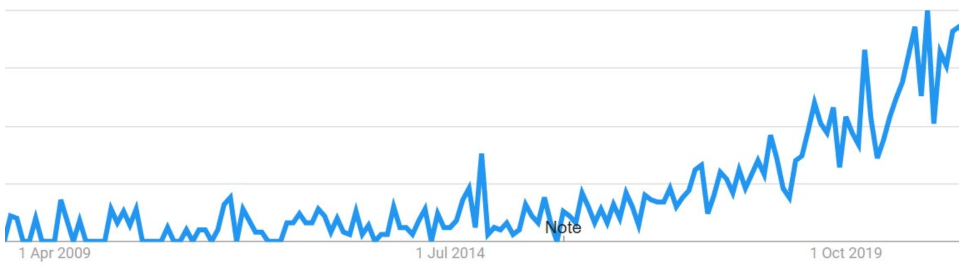

Figure 1 Interest over time in the search term 'ESG investment' worldwide, Google Trends (3 June 2021)

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[1] https://www.consilium.europa.eu/en/press/press-releases/2021/06/01/public-country-by-country-reporting-by-big-multinationals-eu-co-legislators-reach-political-agreement/?utm_source=dsms-auto&utm_medium=email&utm_campaign=Public+country-by-country+reporting+by+big+multinationals%3a+EU+co-legislators+reach+political+agreement

[2] https://www.gov.uk/government/publications/g7-finance-ministers-meeting-june-2021-communique/g7-finance-ministers-and-central-bank-governors-communique

In the EU policy context, sustainable finance is understood as finance to support economic growth, while reducing pressures on the environment and taking into account social and governance aspects. Sustainable finance also encompasses transparency when it comes to risks related to ESG factors that may have an impact on the financial system, and the mitigation of such risks through the appropriate governance of financial and corporate actors. It was noted in the March meeting by a number of contributors that transparency in general (and in particular tax transparency) is a vital element in ensuring effective CSR.

Background to the EU's Sustainable Finance Policies – the 2018 Action Plan

The 2018 Sustainable Finance Action Plan presents a comprehensive strategy to connect finance with sustainability. The plan set out a list of actions to ensure that the financial system supports the EU's climate and sustainable development agenda. It includes ten key actions that are divided into three broad categories. These categories are: *Reorienting capital flows towards a more sustainable economy, Mainstreaming sustainability into risk management,* and *Fostering transparency and long-termism.*

A number of important milestones have followed on from the action plan since then, including the Taxonomy Regulation (which created the world's first ever green list classification system for sustainable economic activities), the Climate Benchmarks Regulation and the Sustainable Finance Disclosure Regulation. The latest milestone deriving from the Action Plan is the Commission's April 2021 package.

Recent Developments – the April 2021 Sustainable Finance Package

On 21 April 2021, the Commission adopted an ambitious and comprehensive package of sustainable finance measures. This package comprises three main elements: The EU Taxonomy Climate Delegated Act (deriving from the abovementioned Taxonomy Regulation), a proposal for a Corporate Sustainability Reporting Directive (CSRD), and six amending Delegated Acts. The aim of this package, just like its predecessors in this area, is to help improve the flow of money towards sustainable activities across the European Union. The package will enable investors to adapt investments towards more sustainable technologies and businesses, and thereby contributing towards making Europe climate neutral by 2050.

The three main elements of the April Package are outlined in more detail in these paragraphs. Firstly, the EU Taxonomy Climate Delegated Act (DA) aims to support sustainable investment by making it clearer which economic activities most contribute to meeting the EU's environmental objectives. The DA lists a number of economic activities in sectors covering the large majority of EU carbon emissions and sets criteria to determine whether each activity makes a substantial contribution to climate change mitigation and climate change adaptation. The criteria also determine whether the activity complies with the principle to do no significant harm to environmental objectives.

Secondly, the Commission adopted a proposal for a Corporate Sustainability Reporting Directive (CSRD), which would amend the existing reporting requirements of the Non-Financial Reporting Directive. The 2018 Non-Financial Reporting Directive (an amendment to the Accounting Directive) lays down rules on disclosure of non-financial and diversity information by certain large companies. The CSRD revises and strengthens these rules. It does this by extending the scope to all large companies and all companies listed on regulated markets. It also requires the audit of reported information, introduces more detailed reporting requirements, and a requirement to report according to mandatory EU sustainability reporting standards. Finally, the proposal also requires companies to digitally 'tag' reported information, so it is machine readable and feeds into the European single access point envisaged in the capital markets union action plan.

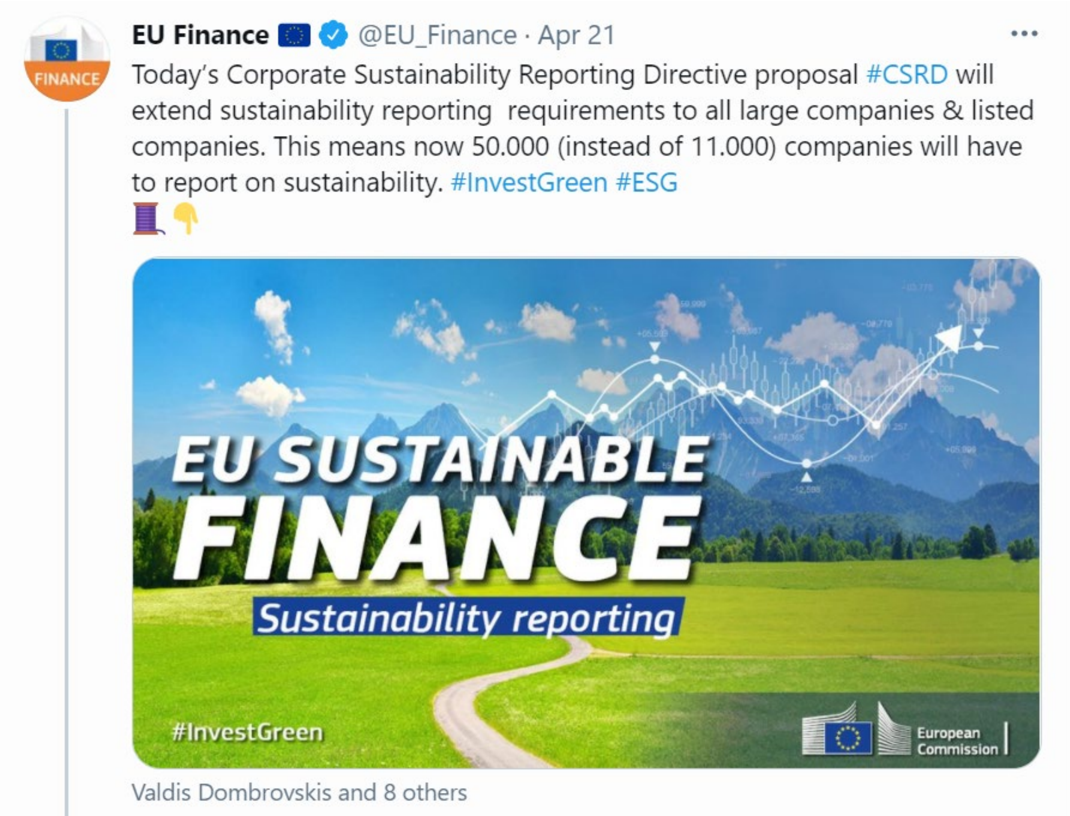

Figure 2 Tweeting about the CSRD proposal, tweet by the European Commission for Financial Markets

Lastly, as part of the April package, the Commission also adopted six amending Delegated Acts on fiduciary duties, investment and insurance advice that will ensure that financial firms, (including advisers, asset managers or insurers) include sustainability both in their procedures and in their investment advice to clients.

Existing tax policies aligned with ESG criteria

A number of EU Member States use tax policy to achieve environmental policy and sustainability goals. Examples can be taxes designed to alter behaviour such as carbon taxes or a plastic bag tax, or alternatively tax incentives for companies to behave in an environmentally responsible manner, a common example across the EU is enhanced depreciation allowances for companies that invest in energy efficient equipment. In addition, tax has a clear role to play in the European Green deal. Specifically the Green Deal announces: a revision of the Energy Taxation Directive (ETD); and, since a Commission evaluation has demonstrated that the ETD is no longer in line with the EU climate objectives, an upcoming revision of the ETD will aim to reflect more accurately the climate impact of various sources of energy and to encourage consumers and businesses to change their behaviour.

What is the role of tax in Sustainable Finance?

In our previous Platform meeting, we discussed the role of tax and Corporate Social Responsibility. In the context of that discussion, we also discussed tax and its importance as an ESG criteria. There were a number of contributions to the March meeting on interlink of tax and ESG. We also heard some examples of government experience, and an additional example of this is the case of Norway, which follows an ethical framework, endorsed by its Parliament, to guide investing by its Government Pension fund. Recently updated, the guidelines now includes tax evasion as part of its definition of financial crimes. Simply put, this means that in practice the Fund managers should avoid investing in, among others, companies that evade tax.[3] Similar provisions have been introduced since years in the EU financial framework, to avoid that EU funds are given to companies having links with non-cooperative jurisdictions for tax purposes.[4]

The question of tax and Sustainable Finance can be examined from two angles. On the one hand, tax is an element of ESG criteria and therefore sustainable finance working effectively will ensure that investment flows to companies that adopt responsible tax policies. For instance, the experience of Norway mentioned above could fit under this angle. The first discussion examined the role of tax as an ESG factor and there was a lot of evidence that investors are increasingly considering the importance of tax as an ESG criterion when making decisions. Investors want to know that the companies they are investing in are pursuing responsible and sustainable tax policies.

The other side of the issue is whether tax can effectively incentivise sustainable finance and achieving ESG objectives. This paper aims to focus today's discussion on this angle of the discussion - does tax have a role to play in encouraging Sustainable Finance? Can tax policies improve the flow of finance to businesses that are committed to ESG criteria? Bearing in mind the risks of economic distortions caused by any tax incentives, the question should also be asked, should tax policy be used in this manner?

There are several ways by which corporate tax policies can contribute to achieving ESG targets. For instance, businesses could take one or more of the following steps:

- mapping and having clarity concerning governmental tax incentives for a greener and more sustainable economy

[3] https://www.regjeringen.no/en/aktuelt/strengthening-of-the-ethical-framework-for-the-government-pension-fund-global/id2843805/

[4] For an overview of this matter, refer to the section "Promoting Tax Good Governance through EU funds" in the July 2020 European Commission tax good governance communication.

- drawing a tax strategy which starts from an existing (environmental) tax contribution of a company and considers possible ways for reducing environmental footprint and its tax consequences, for instance via a shift towards renewable energy sources, more recycling / circularity in the supply chain, use of incentives for purchasing more energy efficient material etc. .
- Analysing the tax aspects of renewable energy projects or of a more sustainable supply chain
- introducing bonuses, rewards or fringe benefits to employees, which promote environmental sustainability; for instance, incentives for commuting in a greener way, leases of electric vehicles, etc.
- proactively adopting, and reporting on, sustainable business conduct, including responsible tax planning and transparency concerning taxes paid

These are only some examples of possible uses of taxation to support sustainable investing and ESG targets. Discussion during the meeting will be likely to provide additional examples and ideas.

Possible areas for EU tax policy to support Sustainable Finance and ESG objectives

The common theme of the EU measures on Sustainable Finance is to improve the flow of money towards sustainable activities across the European Union. Governments have a clear role in allocating public money towards sustainable investments, and this role is now even further reinforced through the focus on the green transition as part of the RRF process. However, for the private sector, could the tax system have a role to play in increasing private investment in those areas of the economy that align with ESG criteria?

The views of delegates are sought on these issues.

Questions for delegates

1. Does tax have a role to play in ensuring the flow of money towards sustainable activities across the European Union?

2. If not, then why not?

3. If yes, then what should that role be? What tax policies could you envisage having a positive effect on sustainable finance and on achieving ESG objectives?

4. What are your suggestions for shaping the work of the Platform on this topic in the future?