A recent event hosted by a range of think tanks looked at current fiscal policy challenges. As public finance plays a role in the transition towards a green economy, it is crucial to examine how the public purse can access and use funds to this end.

That is why this report first looks at the international tax agreement agreed upon in the context of the G20 and the OECD. The deal aims to stop tax evasion by corporations, but it also has distributional effects that need to be examined. Second, the green transition will require public investments. But how do investments affect economic growth, and how can the EU’s fiscal rules be adapted to allow the necessary investments?
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Rich countries profit more from the recently announced OECD tax deal than developing countries, according to a new policy study, putting claims that the global tax system had become fairer into question.

When 136 countries agreed to a tax deal on 8 October, “historic” was one of the most popular descriptions of the result. Commission president Ursula von der Leyen hailed the result as a “historic moment” and “a major step forward in making our global tax system fairer.”

With the roar of approval from rich countries, it was easy to miss the criticism from some less affluent countries who argued that the reform mainly benefitted rich countries. Robert Sweeney, senior economic and policy analyst at the “Think-tank for Action on Social Change” (TASC), has now put numbers to this criticism in a recent policy study commissioned by the Foundation for European Progressive Studies and the Friedrich-Ebert-Stiftung.

THE RICH WIN

The tax agreement stands on two pillars. Firstly, a part of the profit of large and highly profitable firms will

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be allocated to the countries where the revenue is generated instead of the country that hosts the headquarters. Second, a global corporate minimum tax of 15% should put a backstop to the downward spiral of global tax competition.

Sweeney’s main point of criticism is that the allocation of profits in the first pillar of the tax agreement is calculated according to the revenue a company generates in a country. Countries with a large and relatively wealthy population generate more revenue for the companies. They will thus be allocated more of the tax revenue than countries whose citizens have less purchasing power.

“If you allocate taxing rights based on where multinationals generate their revenue, it’s going to hurt poor countries”, Sweeney said.

According to him, other factors than revenue could determine the allocation of taxing rights, for example, where the tangible assets are located or how many employees there are. These factors can be combined in a method called “formula apportionment.”

“If you include the number of employees and tangible assets, that makes the formula more progressive. But to the extent that the formula is weighted towards revenue and payroll, it’s going to be regressive. And the current move to allocate taxes according to revenue is regressive”, Sweeney said, criticising the OECD deal.

In his policy study, Sweeney calculates that high-income countries would receive 26% more corporate taxes than today if the tax allocation was based on revenues exclusively. Upper middle-income countries (e.g. China) would lose 10%, lower-middle-income countries would lose 11%, and low-income countries would lose 50% of their corporate tax revenue in this scenario.

UNEQUAL RESULTS IN EUROPE

The EU would increase its revenues by 14%, according to these calculations.

Within the EU, however, the allocation according to revenue would lead to highly different outcomes. Belgium, Croatia, Estonia, and Greece could double their corporate tax revenues in a revenue-based system. According to the study, Cyprus, Hungary, and Poland would see their corporate tax revenues cut down by half and more.

In addition to his simulations of different ways of tax allocation, Sweeney also calculated the effect of the minimum effective corporate tax rate on tax revenues. While he welcomes the imposition of a minimum tax rate, he thinks it should be 25%.

“There is a nonlinear effect when you move from 15% towards a 25% effective tax rate”, he explained. A move from 15% to 25% would result in much more additional tax revenue than a move from today’s situation to the recently agreed 15%.

ABOLISH THE CARVE-OUTS

Sweeney acknowledged that a minimum effective tax rate of 25% is currently not politically feasible. “It seems to be a done deal, and only the technicalities are yet to be ironed out”, he said.

One of those technicalities is the possibility of carve-outs in the agreement on the minimum effective tax rate. “Companies will be able to reduce the amount of taxation by 10% of their payroll and 8% of their tangible assets for the initial years of the agreement”, Sweeney explained.

“As the deal becomes finalised, I think that it would be feasible for those exemptions to be abolished”, he said.

On 30/31 October, the heads of state of the G20 are expected to greenlight the OECD tax agreement. A directive to implement the minimum corporate tax rate is expected to be proposed by the EU commission in December of this year. The implementation of the tax allocation reform should then be in 2022.
According to a new study, the public sector could take the lead in transitioning to a green economy and help grow the economy at the same time, but only if there is a change in the fiscal rules that are currently debated in the EU.

Some €10 trillion over the coming 12 years is needed to fulfil the EU's commitments under the Paris agreement, according to a study commissioned by the Foundation for European Progressive Studies (FEPS), the think tank of the centre-left political family in the EU.

In this calculation, the study estimates a much larger need for investment than the European Commission. Additionally, the authors of the study argue that the Commission’s approach, focused too much on providing price signals and incentives for the private sector to lead the green transition.

They therefore call for a “large-scale publicly funded investment initiative targeted at putting the
required green infrastructure in place quickly and at scale”.

GREEN INVESTMENTS LEAD TO ECONOMIC GROWTH

The prevailing narrative around the green transition is that it entails a lot of costs and will require sacrifices from people. Moreover, a significant part of the green movement argues that the economy must shrink for the planet to stay within its ecological boundaries.

The FEPS study, however, argues that an investment-led approach to the green transition would have a largely expansionary effect on the economy.

In the long run, the study argues, every euro spent on green investments would lead to an increase in GDP of more than €5, the so-called multiplier effect. The €10 trillion in public investments over 12 years would thus result in a long-term increase of GDP of more than €50 trillion.

Due to this large economic expansion, this investment boom would decrease public debt levels relative to GDP even if the entire programme was financed by public debt.

However, the study heavily depends on its estimation of the multiplier effect, a notoriously difficult economic discipline. A working paper by the International Monetary Fund (IMF) from earlier this year, for example, found considerably smaller multiplier effects for spending on renewable energy than the authors of the FEPS study found for green investments.

Depending on the implementation of such an investment initiative, the positive effect on the economy could therefore be considerably smaller. Furthermore, the effect of public investments on the economy will only be positive if the infrastructure projects are useful and productive.

Naïm Cordemans, an advisor to the Belgian secretary of state for recovery, strategic investment and scientific policy stressed that it takes time to develop good quality projects.

“When you have to go fast, you open the drawer and look at the projects that were not financed before. But these might not be the best ones. There is a reason why they were not financed before”, Cordemans told a panel.

EU FISCAL RULES STAND IN THE WAY OF GREEN INVESTMENTS

At the moment, a public investment initiative of this scale appears politically unfeasible in Europe. The EU fiscal rules that are currently under review are one of the barriers to investments on such a scale.

The fiscal rules impose limits on debt levels and deficits. Crucially, they do not make a difference between investments and other public spending. Even though an investment might lead to GDP growth and therefore contribute to lower debt levels relative to GDP in the long term, the investment might need to be cancelled if it increases the public deficit in the short term.

The European Commission recently called for a broad debate on the future of the bloc’s fiscal rules.

One of the stated aims is to combine a long-term goal of lowering debt levels with increased investments in the green transition.

Another study by FEPS proposes a way out of the dilemma by introducing, among other measures, a “green golden rule” that would enable debt-financed, sustainable investments worth at least 1.5% of GDP.

“A green golden rule could be politically viable in the EU. Not only because green investments are a core priority in Europe but also because the EU has developed a taxonomy to give us an indication on what is sustainable and what is not”, said David Rinaldi, one of the authors of the study.

A recent policy contribution by the economics thinktank Bruegel also backed a “green golden rule”.

Additionally, the authors of the FEPS study proposed replacing the deficit rule with an expenditure rule that would only limit non-investment expenditure.

Anni Marttinen, a macroeconomist at the central organisation of Finnish trade unions, agreed with the general direction of the proposals but warned that it would be hard to define which expenditure should be considered investments and which were sustainable.

“Supervision will be crucial,” she concluded.