Background paper for the Business and Sustainable Development Commission

Aligning corporate tax policy with the Sustainable Development Goals

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1. Introduction

Tax plays a key role in every modern economy. For this reason it is controversial, often forming the focus of disagreements across the political spectrum regarding the role of the state, and the relationship between the public and private sector. Similarly, many businesses justifiably cite tax as a significant obstacle to enterprise development and economic growth.

Despite this controversy however, there is increasing agreement that the interplay between business practice and taxation is of crucial importance to the Sustainable Development Goals (SDGs).

Currently, low-income countries raise an average of just 13% of GDP in revenue. This gives them $400 to spend per person (compared with an OECD average of $13,000 and 34% of GDP)[1]. This isn't enough to deliver the SDGs related to education, healthcare, water and sanitation, infrastructure, governance or social protection – all goods and services that economists suggest can only be effectively provided with some involvement of the state (so-called public and merit goods).

Business tax revenue is a key part of this picture. Corporate income taxes already contribute 17% of total tax revenue in developing countries, almost ten times as much as personal income taxes[2]. Furthermore, a large number of countries raise the same amount or more from taxes on extractive industries[3]. Broadening and deepening this tax base is likely to be central to many countries' efforts to increase the tax take.

However, the SDGs cannot be achieved through revenue-raising alone. There is also an important role for shaping investment incentives for positive sustainable development outcomes. For example, over recent years several developing countries have reformed tax systems in ways that increase business investment and employment (sometimes in addition to raising more revenue), whilst others have successfully used tax instruments to deal with negative environmental externalities such as pollution.

Furthermore, tax policy (and corporate taxation in particular) currently enjoys a high profile in public discourse. Tax has become a normative issue, and whilst this is creating challenges for business (is it better to stick to the legal minimum level of tax required, or pay more in an effort to protect the brand?[4]), it is also creating opportunities for reform.

This paper addresses the relationship between business and taxation. It is structured as follows: section 2 sets out the core design principles for an effective tax system, section 3 outlines the key concerns in aligning tax systems with the SDGs, whilst Section 4 presents a series of specific recommendations for reform; Section 5 concludes by highlighting four 'stand-out' reform ideas.

2. What does a good tax system look like?

In addition to raising sufficient levels of revenue to deliver the services described above, economists agree that good tax systems display a number of basic characteristics[5], each of which is relevant to the SDGs, as following sections will explore:

i. Discouraging behaviours that are undesirable, encouraging those that are desirable, and affecting other incentives as little as possible (in the jargon, internalising externalities, and otherwise maintaining neutrality).

ii. Achieving progressivity[6] (such that a citizen's contribution is based on their ability to pay) and providing a safety net as efficiently as possible.

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[1] Countries classified according the World Bank's Country Income Groups, with tax data for 2013 sourced from the OECD and GDP per capita data (according to purchasing power parity) for 2014.

[2] Willem te Velde D., (2014), 'Mobilisation and effective use of domestic resources for a transformative post-2015 agenda', Overseas Development Institute.

[3] Willem te Velde D., (2014), *op. cit.*

[4] Hardyment R., Truesdale P., and Tuffrey M. (2011), 'Tax as a corporate responsibility issue: the implications for multinationals', Corporate Citizenship

[5] These characteristics have been summarised from the lengthy discussion in the IFS' Mirrlees Review of Taxation (Mirrlees J., Adam S., Besley T., Blundell R., Bond S., Chote R., Gammie M., Johnson P., Myles G., and Poterba J., (2011), 'Tax by design', Oxford University Press. Similar characterisations can be found throughout the economics literature, for example, the OECD's Ottawa Tax Framework Conditions are described as neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility.

iii. Simplicity, which reduces compliance and administration costs.

iv. Tailoring to the national context and its particular challenges (which includes the distribution of earnings and wealth, and – in developing countries – the size of the informal economy, levels of administrative capacity, the state of the social contract, and availability of information[7]).

Any tax system requires some degree of compromise. Some simplicity must be sacrificed to discourage undesirable behaviours, for example. However, most tax and welfare systems could adhere much more closely to these principles, and some relatively small changes could make a big difference.

3. Tax and the SDGs

In line with the principles above, this paper suggests that any attempt to align tax systems with the SDGs must do three things:

- Raise more money in developing countries.
- Send the right signals regarding desirable and undesirable activities; in particular long-term investment, formalisation of informal enterprises and pollution.
- Ameliorate (or at least take account of) a number of challenges to equity and progressivity arising from globalisation and digitisation, not least the widening rift between low and high income earners.

3.1 Raising Revenue

SDG target 17.1 explicitly mentions the need to strengthen domestic resource mobilisation (i.e. raise more revenue) in developing countries, and this is where most of the SDG tax debate has focused thus far. A significant proportion of the money needed to meet the SDGs could be raised through improving domestic tax performance, particularly in middle-income countries. For example, Fenochietto and Pessino's estimates of the best-possible tax take (the tax frontier) suggest that reform could allow a typical MIC to increase spending per person by $1300, enough to address core goals on poverty, education and health in most LMICs[8].

In addition to this and similar studies evaluating broad-based tax reforms, a number of recent papers attempt to quantify the specific impact of eliminating tax avoidance and evasion. Forstater (2015) contains a detailed analysis of these studies[9], many of which suffer serious flaws, but the best estimates tend to cluster between $100bn and $200bn per year for all developing countries (1 to 2% of developing countries' GDP)[10]. These are static estimates and thus over-value the amount that could actually be collected[11], but they nevertheless indicate that reform could generate significant additional revenue in developing countries.

Tax avoidance is far from being the only game in town however. Domestic resource mobilisation is as much about addressing the wider issues affecting tax take – such as the size of the informal economy (perhaps 40% of GDP in many countries[12]), and the poor design of some existing tax systems. In this regard, there are a number of win-win reforms (as evidenced by the case studies in section 4) that can increase tax revenue and improve the investment climate for business at the same time.

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[6] A progressive tax is one where the tax rate increases as the taxable amount rises, such that, for example, high earners contribute a greater share of their income than low earners. In 1776, Adam Smith argued that a citizen's contribution should be based on their ability to pay, and this maxim underlies the desire for progressivity (Smith A., (1776), 'The Wealth of Nations', available in a modern edition from Penguin Books).

[7] On these issues, see for example Tanzi V. and Zee H., (2001), 'Tax policy for developing countries', *Economic Issues number 27*, and IMF, OECD, UN and World Bank (2011), 'Supporting the development of more effective tax systems', Report to the G20.

[8] Greenhill R., Carter P., Hoy C. and Manuel M. (2015), 'Financing the Future', Overseas Development Institute.

[9] Forstater M. (2015), *op. cit.*

[10] Forstater M. (2015), *op. cit.*

[11] Any change in tax policy would lead to changes in behaviour, feeding back into reduced tax revenue in other areas (for example through reduced personal income taxes), as well as potentially affecting investment.

[12] Chatham House (2010), 'Registering for Growth: Tax and the Informal Sector in Developing Countries', Chatham House

3.2 Discouraging undesirable behaviours and encouraging desirable behaviours

Encouraging enterprise and investment: Tax systems must strike a balance between encouraging the investment and enterprise that ultimately creates all wealth and jobs, and raising sufficient revenue to deliver public services (many of which – such as education and infrastructure – also support private sector activity). Set rates too high, and foreign businesses may chose to invest elsewhere whilst domestic businesses chose to remain in the informal economy. Set the bar too low, and revenues are needlessly lost, with associated deterioration in public infrastructure, education, healthcare and other services.

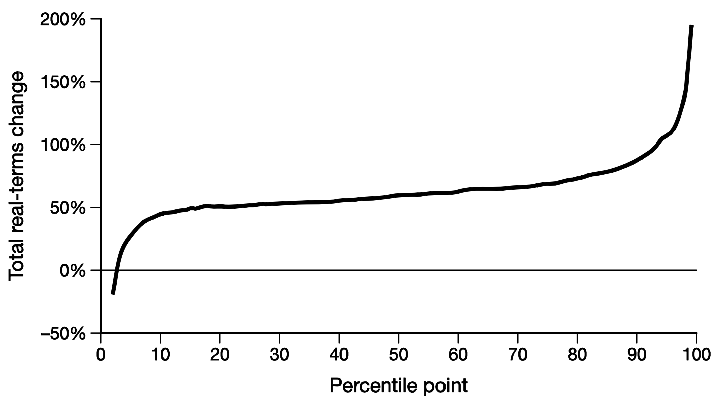
Discouraging pollution: At the same time, tax systems need to get much better at genuinely incentivising 'green growth'. In India, 23% of childhood deaths can be attributed to polluted air, contaminated water or other environmental problems[13]. Globally, climate change is expected to cause an extra 250,000 deaths a year between 2030 and 2050, according to the World Health Organisation[14]. As Muthukumara Mani, the World Bank's Senior Environmental Economist has observed, "'Grow now, clean up later' really doesn't work" [15].

Encouraging long-termism: Environmental degradation arises partly because humans tend to over-value immediate rewards relative to long-term pay-offs, and there is a case for specific taxes that help correct this particular bias[16,17]. This tendency also helps drive a focus on short-term profits and gives rise to suboptimal levels of saving and investment (a certain amount of which is key to achieving the SDGs on energy, infrastructure, and cities).

Discouraging social bads: There are also a number of specific goods with detrimental health effects that can be targeted by tax instruments. This list includes tobacco, alcohol, sugar and narcotics. Their over-consumption poses a significant risk to SDG three on health and wellbeing. For example, by 2030, more than two-thirds of diabetes cases are expected to be in the developing world[18], with associated increases in early mortality.

3.3 Challenges to equity and progressivity

In developed countries, the gap between the lowest and the highest paid workers has widened significantly over recent years. Taking the UK as an example, chart 1 shows increases in personal incomes (adjusted for inflation) between 1979 and 2009/10, according to one's initial starting point in the income distribution.



[13] World Bank (2013), 'India: Diagnostic Assessment of Select Environmental Challenges Volume 1', report Number 70004-IN; see also Financial Times (2013), 'Environmental damage costs India $80bn a year', written 17th July 2013, accessed 6th May 2016
[14] WHO (2015), 'Climate Change and Health', Factsheet Number 266
[15] Financial Times (2013), *op. cit.*
[16] A certain amount of cash today is worth more than the same amount tomorrow for a number of good reasons (risk and inflation for example), but the extent of present bias goes far beyond these 'traditional' economic concerns.
[17] O'Donoghue, T. and Rabin M., (1999), "Doing It Now or Later", American Economic Review 89, 103-124.
[18] Frank B., (2011), 'Globalisation of Diabetes', *Diabetes Care* Volume 34 Number 6

Figure 1: Income growth between 1979 and 2009/10 according to starting point in the income distribution, Great Britain. Source: Mirrlees *et al*, *op. cit.*, page 9

It shows that those who were already earning the most in 1979 have seen their incomes rise much more than everyone else, whilst those who were earning the least have seen little if any wage growth. Researchers at the UK's Institute for Fiscal Studies have concluded: *"poverty has become much more of an in-work phenomenon since the 1970s, as increasing earnings inequality… and relatively slow growth in earnings… have pushed more low and middle earners into poverty. This shift… is a major socio-economic change.*[19]*"*

This has been driven – in large part – by globalisation. PwC's recent briefing on tax reform in the UK suggests that whilst lower skilled workers have seen their incomes held down by competitive pressure resulting from globalisation, the extra mobility enjoyed by highly skilled workers and owners of capital has increased their earning potential (and ability to benefit from tax arbitrage)[20].

Furthermore, the rise of the digital economy appears likely to exacerbate this trend. Kim Taipale and David Bollier suggest that it causes what they call a 'power curve distribution of income and wealth'[21], where a small group reap a disproportionate share of the benefits in a market. And many authors also suggest that automation of work will exert further downward pressure on the wages of low and mid-skilled workers[22].

These changes in business practice also affect low and middle-income countries. Globalisation and digitisation create opportunities for economic development, but the benefits are not evenly distributed between workers in these countries. The lowest-skilled workers can be left behind, and the data suggests that this is increasingly the case in many nations[23].

3.4 The challenging economic context

Existing tax frameworks were established when work, income and savings were well defined by geography. Relatively recent trends in business practice have changed this.

Between 1990 and 2011, trade increased from 40% of global GDP to more than 60%[24]. At the same time, investment flows have become much more international, with foreign direct investment as a share of global GDP tripling between 1990 and 2007[25]. The digital economy is likely to strengthen these existing trends by facilitating *much* greater global integration: digital services may be developed in one country, hosted on equipment in another, managed in another, and consumed somewhere else.[26]

These developments pose serious challenges for an international tax system designed when businesses were defined by geography. As a result, international businesses complain of double taxation, whilst activists and governments complain about profit shifting and the use of international tax havens[27]. According to Mirrlees *et al*, "*a high proportion of the significant legal disputes between companies and tax authorities involve the treatment of cross-border transactions.*[28]"

Almost everyone loses out from this existing arrangement, through higher compliance burdens for business, higher administration costs for government, and reduced tax revenue, especially in

[19] Page 135; Cribb J., Hood A., Joyce R., and Phillips D., (2013), 'Living standards, poverty and inequality in the UK: 2013'. Institute for Fiscal Studies Report R81
[20] Sentance A., (2014), *op. cit.*
[21] Bollier D., (2013), 'Power curve society: the future of innovation, opportunity and social equity in the emerging networked economy', The Aspen Institute
[22] Frey C. and Osborne M. (2015), 'Technology at work: the future of innovation and employment', Citi GPS Report. See also Brynjolfsson E., and McAfee A., (2011), 'Race against the machine', Digital Frontier Press.
[23] The Economist (2014), 'Revisting Ricardo: why globalization is not reducing inequality within developing countries', The Economist, August 23rd 2014.
[24] The Economist (2014), 'A troubling trajectory', published December 13th 2014. Incidentally, as this article mentions, whilst growth in international trade appears to have slowed since 2011, this is potentially because of the statistical difficulties related to capturing rapidly expanding trade in intangibles such as software.
[25] Data from OECD.stat, based on BMD3. See also Sentance A., (2014), 'A tax system fit for the future', PwC
[26] OECD (2014), 'Addressing the tax challenges of the digital economy', OECD.
[27] Mirlees *et al* (2011), *op. cit.*
[28] Page 429, Mirlees *et al* (2011), *op. cit.*

developing countries, who do not have the capacity to enforce more complex forms of corporate taxation.

4. Building an SDG-aligned system of business taxation

4.1 Reimagining the Social Contract

"I like to pay taxes. They are the price I pay for civilisation"

Oliver Wendell Holmes Jr (former US Chief Justice)

At a fundamental level, the challenges identified in section three require a reimagining of the social contract between citizens, business and government. Tax is simply the most visible manifestation of this implicit contract, which describes the roles and responsibilities commonly associated with each of these three groups, according to prevailing social norms and values.

Writing more than a decade ago, Ian Davis (then McKinsey's global Managing Director) suggested that business needed to seize the initiative in this area, and articulate an alternative social contract that goes beyond complying with the law or even corporate social responsibility[29]. This remains true today. Tax can be conceptualised not as a cost, but as an investment – an investment in the future ability of society to support and maintain the conditions that business requires: law and order, infrastructure, an educated workforce, stability, and so on.

The role for business is threefold:

- Lobby for constructive reforms;
- Keep within both the letter and spirit of tax law (by taking a more purposive reading of the intention of legislation for example[30]);
- Provide information that helps the public to hold government to account, particularly where there is a risk of corruption.

4.2 Specific Recommendations for Reform

Society's changing values will eventually be reflected in new tax legislation, and it is already possible to identify some of the contours that this regulation will describe - witness, for example, the OECD process on base erosion and profit shifting (BEPS), or recent legislation regarding country by country reporting. Our objective here is to contribute to the debate by identifying several of the reforms necessary to align tax systems with the SDGs. We focus on three pivotal areas of business taxation: corporate income tax, incentives for investment and formalisation in the developing world (related to corporate income tax and beyond), and environmental taxes. However, we also provide recommendations for two more minor areas (capital gains and property taxation), where these would support reform in our three focus areas.

We organise these reforms into three groups:

A: those that require major capacity building or other support before they can begin,

B: those that can and should be implemented immediately, without much additional support;

C: those that require further research or would be introduced as part of a wider package that goes beyond tax policy.

Table 1 summarises our recommendations.

[29] Davis I., (2005), 'The biggest contract', The Economist, May 26th 2005.

[30] Devereux M., Freedman J., and Vella J. (2012), 'Tax Avoidance', Oxford University Centre or Business Taxation. First of three papers commissioned by the UK's National Audit Office.

Table 1: Options for Tax reform

Reform	Focus	Raise more money in developing countries	Encourage desirable/discourage undesirable activities	Increase equity and progressivity
A. Reforms that require major capacity building or other support before they can begin				
A1. Implement OECD BEPS actions	Corporate Income Tax	▯ (if accompanied by significant international support)		▯ (in developing countries)
A2. Reform investment incentives	Corporate taxation	▯ (requires technical assistance to support the analysis and policy design required)	▯ (focuses on tools that genuinely increase investment)	▯
A3. Increase use of simplified tax codes to encourage formalisation	Encouraging formalisation	▯ (widens tax base)	▯ (encourages formalisation)	▯ (widens participation in social security systems)
A4. Increase overall importance of property taxation within tax system	Property taxation	▯ (successful examples include Sierra Leone and Namibia)	▯ (Land Value Taxes encourage investment in agriculture, as in Namibia)	▯
B. Reforms that can be implemented immediately, without additional support				
B1. Shift burden of taxation onto environmental bads	Environmental taxation	▯	▯ (encourages improved environmental practice)	
B2. Take advantage of current low oil prices to phase out energy subsidies and tax breaks	Environmental taxation	▯	▯	
B3. Public country by country reporting	Corporate Income Tax (Tax transparency)	▯ (empowers local civil society to hold government to account, encourages compliance)		▯ (in developing countries)
B4. Beneficial ownership	Tax transparency	▯		▯
B5. Eliminate loophole regarding inherited assets	Capital gains		▯	▯
C. Reforms that require further research, or a wider package of measures beyond tax policy				
C1. Investigate options for fundamental reform of source-based profits taxation	Corporate Income Tax	▯		▯
C2. Reduce bias towards debt over equity finance	Corporate taxation		▯□ (as part of package to encourage long-term investment)	
C3. Taper tax rate over time for gains related to equity	Capital Gains Taxes		▯ (as part of a package to encourage long-term investment)	
C4. Align rates more closely with income tax rates	Capital Gains Taxes	▯		▯

A: Major reforms that require significant additional capacity building

A.1 The OECD's Base Erosion and Profit Shifting Reforms

At present, corporate profits are generally taxed according to where economic activity (i.e. production in its broadest sense) takes place, rather than where products are sold, or the where the business' owners live[31]. As a result, when production occurs in different jurisdictions, the attribution of profit between national subsidiaries of the same business depends upon the transfer prices charged by one subsidiary to another for provision of their goods and services. There is often little transparency regarding the appropriate value (or market price) of these goods and services, and highly mobile assets such as IP can also be relocated to the lowest tax jurisdiction with negligible cost.

Launched in 2013, the OECD and G20 'Base Erosion and Profit Shifting' (BEPS) project aims to tackle the 'gaps and mismatches in tax rules' allowing corporations to shift profits to low or no tax locations[32]. BEPS has particular relevance to developing countries because they tend to be more reliant on corporate income tax than higher income countries. The IMF estimates that developed countries lose up to 1.3% of GDP (compared with a tax take of 13% in LICs and 18% in LMICs[33]), while developing countries lose up to 1% of GDP (against an OECD average tax take of 34%[34])[35].

The business community has broadly welcomed the framework on the basis that it has helped to bring certainty to longer term planning and minimise costs from legal challenges. According to PricewaterhouseCoopers (PwC) BEPS 'heralds the most comprehensive reform of international taxation ever'[36].

Implementation of BEPS is moving swiftly amongst OECD and aspiring OECD countries, but – despite having the most to gain from reform – many developing countries lack the legislative measures and capacity required. This follows partly from the initial failure of the BEPS project to consult developing countries and identify the particular challenges they face. In response, the OECD has widened its engagement. Developing countries, the UN, IMF and World Bank will all be involved in the monitoring and implementation of the BEPS recommendations, and following the UN Financing for Development Conference in Addis Ababa, more than 30 countries committed to double their support for technical cooperation in the area of taxation by 2020.

This much is clear: successfully addressing BEPS could be a major generator of additional tax revenue in developing countries and could also reduce tax uncertainty for business: a potential win-win. However, many of these countries will only be able to reap these benefits through a systematic and targeted effort to build their capacity and governance structures. Some promising initiatives have recently been established (such as Tax Inspectors Without Borders, whereby developing countries access expert help with tax audits), but the way in which they are implemented and scaled up will be crucial to the effectiveness of the BEPS project.

If successfully implemented, these reforms are likely to be progressive in many developing countries, despite uncertainty over the precise incidence of corporation tax. This is because, whilst is unclear to what extent corporate taxes are borne by shareholders rather than employees[37], in developing countries, the poorest segments of society tend to work in the informal sector and thus – even if corporate taxes are shifted onto workers – they will tend to fall on those benefitting from economic development rather than the poorest[38].

[31] Some passive income is taxed according to residence, but this is the exception that proves the rule. Mirlees *et al* (2011), *op. cit.*
[32] For more information see http://www.oecd.org/ctp/beps-about.htm
[33] Mascagni G., Moore M., and McCluskey R., (2014), 'Tax mobilization in developing countries: issues and challenges', report commissioned from the European Parliament Directorate General for External Policies from the Institute for Development Studies.
[34] Countries classified according the World Bank's Country Income Groups, with tax data for 2013 sourced from the OECD
[35] E. Crivelli, R. De Mooij and M.Keen, 'Base erosion, profit shifting and developing countries*, IMF Working Paper*
[36] See PwC (2015), 'Building public trust through tax reporting: developing a communication plan for tax', and http://www.pwc.co.uk/services/tax/beps-index.html
[37] Lang M., Herdin J., and Hofbauer I. (2005), 'WTO and Direct Taxation', EUCOTAX series on European taxation, Published by Kluwer Law International, The Hague.
[38] Bird R., and Zolt E., (2003), 'Introduction to tax policy design and development', World Bank

A.2 Reforming Incentives for Investment in Developing Countries

World Bank enterprise surveys of more than 135,000 businesses across 135 countries show that over 30% of companies cite tax rates as a major constraint[39]. Getting tax rates and incentives right can be notoriously difficult. Prohibitively high rates deter business investment, but very low rates deprive government of the revenue required to provide the ancillary services (such as infrastructure, macroeconomic stability, the rule of law and property rights) that enterprise surveys show weigh much more heavily on a firms' decision to invest in poorer countries than tax rates themselves[40]. In some cases, reform offers a win-win: improving incentives for investors and raising more tax revenue at the same time.

The use of tax incentives has become more widespread in Low Income Countries (LICs) in recent decades – with 80% of countries in sub-Saharan Africa now offering tax holidays compared to only 40% in 1980, and 50% operating 'free zones' (tax-free economic areas), which were non-existent 30 years ago[41]. The stated aim of such incentives is to attract much-needed investment - by all companies, but particularly targeted at foreign direct investment (FDI). However, there is clear evidence that in many cases existing incentives are not working effectively[42]. For example, the OECD report that in one recent survey of investors in a number of African nations, 90% would have invested without the provision of incentives[43].

One of the fundamental causes of poor incentive policies is the often opaque and piecemeal way in which tax breaks are agreed. These policies are often not backed by any rigorous data or analysis[44], require no parliamentary approval, and can be introduced on an ad-hoc basis by decree or other direct measures[45]. This is a lose-lose situation. It results in tax uncertainty for investors – who cannot be sure that tax breaks will remain in place once an investment has been made – and it allows powerful vested interests to reduce the tax take without due process or oversight.

Partly as a result of this lack of transparency, the cost of existing tax incentives is hard to estimate, but they can be very significant. In the East Caribbean Currency Union they were estimated at more than 10% of GDP according to the OECD[46]; and in Rwanda the Institute for Policy Analysis and Research suggests they are worth around a quarter of all potential tax revenue (although this figure may be unusually high).[47]

Win-win reform is possible. Evidence suggests that complex, piecemeal incentives and exemptions are often better replaced by simplified systems with more competitive standard rates of corporate income tax, and reductions in the number and complexity of payments. Such approaches are not only more attractive to business, but also reduce bureaucracy and administration costs[48]. And where tax incentives are applied, targeted schemes such as investment tax credits and accelerated depreciation schemes have been shown to yield more investment per dollar spent than tax holidays or general exemptions[49].

CASE STUDY: Shifting or eliminating tax incentives[50]

There are multiple examples of countries which have either shifted or abolished tax incentives altogether and reformed tax systems to attract business and investment in other ways.

In Ghana tax holidays were eliminated through major tax reforms in 1997, and replaced with a 30% tax on

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[39] World Bank Group (2016), 'Enterprise Surveys, Regulations and Taxes', World Bank.
[40] Kinda T., (2014), 'The Quest for Non-Resource-Based FDI: Do Taxes Matter?' IMF Working Paper
[41] IMF, OECD, UN and World Bank (2015), 'Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment', Report to the G20
[42] *Ibid.*
[43] OECD Principles to enhance the transparency and governance of tax incentives for investment in developing countries, available at http://www.oecd.org/ctp/tax-global/transparency-and-governance-principles.pdf
[44] IMF, OECD, UN and World Bank (2015), *op. cit.*
[45] OECD Principles, *op. cit.*
[46] OECD Principles, *op. cit.*
[47] Institute for Policy Analysis and Research (IPAR) and Action Aid Rwanda (2011), 'East African taxation project: Rwanda country case study', IPAR.
[48] OECD (2008), 'Tax Incentives for Investment - A Global Perspective: Experiences in MENA and Non-MENA countries' in 'Making reforms succeed: moving forward with the MENA investment policy agenda', OECD Publishing.
[49] IMF, OECD, UN and World Bank (2015), *op. cit.*
[50] OECD (2008), *op.cit.*

corporate income, along with more extensive capital allowances and reduction on import duties on a range of capital goods. Following these reforms, foreign direct investment increased by 70% and the tax take increased significantly (by 1% of GDP).

Indonesia abolished a range of tax incentives through reforms in 1984 - including tax holidays, preferential rates, special investment allowances and selective accelerated depreciation – whilst decreasing the overall corporate income tax rate from 45% to 35%. FDI reached unprecedented levels three years later.

Egypt abolished all tax exemptions through a new tax law in 2005, whilst simultaneously lowering corporate income tax from 40% to 20%, and streamlining tax rates and procedures. Within the first 6 months following the new tax law, FDI had doubled.

More fundamentally, creating a policy environment conducive to reform requires three things:

- Transparency. Existing incentive schemes should be consolidated and published, alongside an assessment of their costs and benefits (and in particular, who benefits)[51].
- New schemes should be subject to parliamentary approval through the normal legislative processes for tax policy[52].
- Rigorous analysis should be carried out to assess whether incentives are worthwhile. Support from the international community can make a significant difference in this regard: investments supported by donors in the Rwandan Revenue Authority led to an increase in the percentage of its domestic revenue from taxation rising from 8.4% of GDP in 1992, to 14.2% in 2008[53].

A.3 Encouraging formalisation

Evidence suggests that the informal economy could be equivalent to around 42% of GDP on average in developing countries[54]. This deprives governments of much-needed revenues, and constrains economic growth by limiting (informal) firms' access to credit, enforcement of contract, public procurement and access to training programmes[55]. Furthermore informal businesses who operate outside the tax net present unfair competition to formal enterprises[56], sometimes creating a vicious cycle whereby governments increase the tax burden on formal companies in order to compensate for revenues lost to the informal economy, but in doing so reduce incentives for formal investment (and for formalisation itself).

Informality is also an equity issue. Informal workers often lack access to the legal protection and social security coverage that comes with formal employment, and face a riskier operating environment. In Brazil, the benefits foregone include access to holiday pay, sick leave, medical access, maternity leave and pension contributions[57].

There are many causes of informality (including the cost, complexity and time associated with incorporation in many countries). However, overly burdensome and complex tax systems can also be a key driver[58], where (especially small) enterprises chose to remain in the informal sector as they do not perceive the benefits of formalisation to outweigh the time, effort and financial costs associated with paying tax[59,60].

[51] *Ibid.*
[52] OECD Principles, *op. cit.*
[53] African Development Bank (2010), 'Domestic Resource Mobilisation for Poverty Reduction in East Africa: Rwanda Case Study', ADB. '
[54] Chatham House (2010), *Registering for Growth: Tax and the Informal Sector in Developing Countries,* Chatham House.
[55] Institute for Development Studies (IDS), International Centre for Tax and Development (ICTD) (2013), *Taxing the Informal Economy: Challenges, Possibilities and Remaining Questions*,
[56] IFC (2010), *Scaling up Access to Finance in the Developing World, Stocktaking report for the G20 Summit*,
[57] International Labour Organisation (ILO), *Transitioning from the informal to the formal economy* (2013), ILO
[58]Schneider, F, Buehn, A and Montenegro, C. (2010), 'Shadow Economies all over the World: New Estimates for 162 Countries from 1999 to 2007', World Bank Policy Research Working Paper Series No. 5356.
[59] For a comprehensive overview of the different motivations driving informality, see Chen, Martha Alter (2012), 'Informal Economy, Definitions, Theories and Policies', *WIEGO.*
[60] IIED (2011), 'The Informal Economy: A Primer for development professionals on the importance of the informal economy in developing countries', International Institute for the Environment and Development

Introducing a tailored and simplified tax schedule can make a significant difference when used alongside other efforts to promote formalisation[61]. Where informal businesses cite taxation as a major barrier, it is as much the multiplicity, complexity and protracted administration of taxes that present a problem as the tax rates themselves[62]. This can be addressed through providing favorable taxes for micro, small and medium enterprises (which comprise the vast majority of informal entities), integrating a range of different taxes into one single tax payment, and simplifying payment facilities within the tax regime[63]. In Brazil the introduction of the 'Simples Nacional' - along with a specific law for individual entrepreneurs – helped to streamline the collection and payment of taxes. Similarly Chile introduced a law in 2007 that made tax compliance easier and cheaper for SMEs.[64]

The ability to design, implement, monitor and enforce a formalisation strategy that brings the majority of economic actors under the tax net, will often require improvements in technical governance capacity, which is a key area where the international community (via North – South and South-South cooperation) can play a positive role.

CASE STUDY: Successful formalisation strategies in Brazil[65]

Between 2002 and 2012, Brazil was able to achieve a 15.6% increase in the percentage of the working population engaged in formal employment. Tax reform played an important role in this process. The establishment of the Simples Nacional in 2006, instituted a new and simplified tax and contribution system combining a range of taxes applying to micro and small enterprises. This reduced the tax burden overall and made the system less onerous, thereby increasing the incentive to formalise.

Alongside changes to the tax system, in 2010, the 'General Act on SMEs' was introduced, which coined the legal concept of the "individual micro-entrepreneur". Through a simple registration system and a single payment, a certificate is issued that gives access to social security, medical care and maternity leave. Figures suggest that over 3 million workers have been formalized in this way.

This package of provisions for formalisation reduced the financial and administrative burden of the tax system, as well as creating differentiated laws that specifically target the needs of micro, small and medium enterprises and informal entrepreneurs. This – combined with the provision of tangible social security benefits in return for registration and tax payments – has succeeded in significantly widening the tax net, with substantial increases in tax revenue from small businesses who have now formalised.

A.4 Property Taxes

Property taxes typically fund local government and thus lack a strong champion internationally or on the national political scene[66]. However, well-designed property taxes are amongst the most efficient and growth-friendly of all taxes, according to the OECD[67], and are immune to the problems afflicting less well geographically defined tax bases. Furthermore, economic analysis tends to indicate that they are highly progressive, falling principally on those who own land or live in high value accommodation[68] [69].

When well-designed, they stimulate business activity. They are often credited with clarifying land tenure, particularly for those in informal housing, which provides them with the collateral required to

[61] IDS and ICTD (2013) *op. cit.*
[62] World Bank Group (2007), 'Designing a Tax System for Micro and Small Businesses: Guide for Practitioners,' World Bank.
[63] ILO and FORLAC (2014), Policies for the formalisation of micro and small enterprises, ILO. For more information on the significant increase in tax collection, see: Schwingel, I & Rizza, G. (2013), 'Políticas públicas para as empresas a formalização das empresas', Brasília.
[64] *Ibid.*
[65] Based on Pochmann, M. (2016), 'Policies for the Formalisation of micro and small enterprises in Brazil', ILO Brazil; ILO (2014), 'Transitioning from the Formal to the Informal Economy', ILO.
[66] Moore M., (2013), 'Wanted Worldwide: sensible property taxes and a property tax champion', ICT CEO's blog, http://www.ictd.ac/index.php/wanted-worldwide-sensible-property-taxes-and-a-property-tax-champion
[67] The Economist (2013), 'Levying the land', Published June 29th 2013
[68] Bahl R., Martinez-Vasquez J. and Youngman J., (2008), 'Making the property tax work', Lincoln Institute of Land Policy, Cambridge Massachusetts
[69] The value of a property depends first and foremost on its location, and is driven largely by the quality of local schools, transport links and other taxpayer-funded infrastructure. Property taxes thus ensure that all taxpayers capture some of the benefits of the infrastructure that they have funded, rather than letting these benefits accrue solely to those who live nearby.

access credit to start or expand a business, for example[70]. Furthermore, by imposing a small cost of the value of land – independent of the way it is used - they create an incentive to employ it as productively as possible, rather than simply holding it the expectation that it will increase in value[71]. This effect stimulates investment and is most powerful in the case of a pure land value tax, based on the worth of the land itself, rather than any buildings or development sitting on top of it[72]. Namibia recently introduced a tax on the unimproved value of agricultural land with a basic rate of 0.75%, intended to encourage efficient land use[73] and Estonia, Denmark, Australia and New Zealand have somewhat similar systems.

In his 2013 IMF working paper, Norregaard asserts that the "revenue-raising potential [of property taxes] is largely untapped in many countries,"[74] and suggests that over a 5-10 year horizon, reforms in developing countries could raise half a percentage point of GDP or more. With LICs raising just 13% of GDP in tax currently (on average), this is a relatively significant increase over a short period. Furthermore, as a country develops, the share of GDP that can be raised from property increases, to well above 2% of GDP in high-income countries (currently 3.5% in Canada, more than 10% of the total tax take) [75].

In light of these advantages, there is a strong case for a greater focus on property taxes around the world, and particularly in developing countries.

CASE STUDY: Property Tax Reform in Post-Conflict Sierra Leone[76]

When Sierra Leone emerged from a decade long civil war in 2002, the newly formed government and international community believed that decentralisation was essential to reducing the risk of further conflict. Property tax reform was a major driver of success in providing own resources for the four city councils that were created by this decentralisation policy. In Makeni for example, the tax take from property taxation increased from close to zero in 2006 to Le 1500 per capita in 2010 (approximately 40 US cents, or – as a rough indicator – 0.1% of GDP per capita), accounting for more than 40% of city council tax revenue. The property tax introduced is highly progressive, being described by Jibao and Prichard as "for all intents, a tax on wealth".

The success of property tax reform in a post-conflict low-income country with very low levels of tax capacity has surprised many observers. Research attributes the success to the role of on-the-ground technical advisors provided by the international community and the strong political leadership required to push through transparency, monitoring and enforcement measures in the face of vested interests (particularly large property owners).

B: Reforms that can be implemented without additional support

B.1 Shifting the burden of taxation onto environmental bads

2015's historic climate agreement at COP 21 in Paris sent a clear signal regarding the need for further decarbonisation. Well designed environmental taxes[77] can ensure that businesses and consumers both take environmental costs into account in their activities and incentivise innovation[78], helping drive progress towards decarbonisation and other environmental objectives.

These taxes can also help stimulate sunrise industries and develop new areas of competitive advantage. The Confederation of British Industries (CBI) conclude that when environmental taxes put a price on a specific activity, and it is applied carefully to avoid market distortions, there is then an

[70] Ahmad E., Brosio G and Poschl C. (2014), 'Local property taxation and benefits in developing countries – overcoming political resistance', Asia Research Centre Working Paper 65, London School of Economics
[71] Norregaard N., (2013), 'Taxing Immovable Property: Revenue Potential and Implementation Challenges", IMF Working Paper WP/13/129
[72] The Economist (2013), 'Levying the land', Published June 29th 2013
[73] Norregaard N., (2013), op. cit.
[74] Page 4, Norregaard N., (2013), op. cit.
[75] Norregaard N., (2013), op. cit.
[76] Based on Jibao S., and Prichard W., (2013), 'Rebuilding local government finance after conflict: the political economy of property tax reform in post-conflict Sierra Leone', ICTD Working Paper 12, Institute of Development Studies
[77] A tax whose tax base is a physical unit (or a proxy of it) that has a proven specific negative impact on the environment. Four subsets of environmental taxes are distinguished: energy taxes, transport taxes, pollution taxes and resources taxes. (OECD 2005).
[78] OECD. Taxation, Innovation and the Environment. OECD green growth strategy. 2010

incentive for businesses to invest in methods to change their behaviour, reducing the amount they pay in tax and potentially establishing a point of competitive advantage[79]. As such the CBI 'recognise that environmental taxes, if well designed, can help the economy, the exchequer and the environment'[80]. They are also often preferred to regulation, given their transparency for business in coverage and costs[81].

Indeed the countries that have experimented with green taxation have found long-term environmental benefits without harming economic growth. For example, in Denmark the government levies taxes on harmful products (such as pesticides and insecticides); on the discharge of pollutants (e.g. wastewater and carbon dioxide); and on scarce resources (e.g. water and raw materials). Since 1986 when the tax regime started to evolve, energy consumption has remained constant but emissions have decreased and real GDP has grown by 50%[82]. British Columbia's recent carbon tax (see box) exhibits similar characteristics.

Environmental taxation has also played a key role in encouraging innovation in several countries (in fact, evidence suggests that in the absence of accompanying tax policy, incentives aimed at environmental R&D can be rather ineffective[83,84]). In Sweden, the introduction of a tax on NOx emissions led to a dramatic increase in the adoption of existing carbon-reduction technology: only 7% of firms had adopted such technology when it was introduced; that had risen to 62% a year later. As such, environmental taxes can help ensure that firms lagging on environmental performance keep up with the leaders.

CASE STUDY: British Columbia's revenue-neutral carbon tax[85]

In 2008 British Columbia, Canada, introduced the first large scale carbon tax in North America. By 2012, the tax had reached a level of C$30/t CO2 and covered three-quarters of all greenhouse gas emissions in the province. By law, the carbon tax must be revenue neutral, so the province has cut income and corporate taxes to offset the revenue it generates from taxing carbon. For example, revenues have been distributed to lower income residents through a tax credit system. The results of the tax have been impressive. Per-person consumption of fuels has dropped by 16% since 2008 (during that same period, per-person consumption in the rest of Canada rose by 3%.). The evidence finds no measurable impact of the tax on overall economic output.

There is clear scope for greater use of environmental taxes. On average, OECD countries raise less than 2% of government revenue in this way[86], compared with more than 6% in Europe[87] and 10% in the Netherlands[88] (from taxes on energy products alone).

Historically developing countries have not raised significant revenues from environmental taxes either, but there are some notable exceptions. In 2009, the revenue from all of Tanzania's environment taxes (including fuel duties and taxes on vehicles) accounted for 18.5% of total tax revenue in Tanzania, exceeding any OECD country[89]. Other developing countries have used levies to improve environmental practices: Cameroon's forestry taxation regime has succeeded in increasing local processing, sharing forest rents more equitably and improving governance and transparency in the sector[90]. Uganda's Sustainable Fisheries User Levy[91] raises US$2.46 million annually of which approximately one-fifth is paid into the general budget and the remainder invested in improving management practices.

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[79] S. Mayne, et al. 2012. Solving a taxing puzzle; making environmental taxes work for business Confederation of British Industry
[80] *Ibid.*
[81] OECD (2011), 'Environmental taxation: a guide for policy makers', OECD
[82] Sourced from Eurostat's environmental tax statistics.
[83] OECD (2012), 'Taxation, innovation and the environment', OECD green growth strategy.
[84] *Ibid.*
[85] Murray B. and Rivers N. (2015), "British Columbia's revenue neutral carbon tax: a review of the latest 'grand experiment' in environmental policy." NI WP 15-04. Durham, NC: Duke University.
[86] Sourced from OECD.stat
[87] Sourced from Eurostat's environmental tax statistics.
[88] Vollebergh H., (2015) 'Green tax reform: energy tax challenges for the Netherlands,' The Netherlands.
[89] GIZ (2014), 'Environmental fiscal reform – case studies', GIZ, Bonn, Germany.
[90] Topa G. *et al.* (2009), 'The rainforests of Cameroon: experience and evidence from a decade of reform'. World Bank
[91] Milne J. *et al.* (2003). 'Critical issues in environmental taxation'. Oxford University Press, Oxford.

Given these success stories, there is a compelling case for increasing the role played by environmental taxation in both developed and developing countries. These taxes offer a clear win-win, generating revenue (either to increase the tax take or allow tax cuts elsewhere), improving environmental practice and in some cases creating new opportunities for business.

B.2 Take advantage of low oil prices to eliminate fossil fuel subsidies and tax breaks

Consumer fuel subsidies drain government revenues in many poor countries whilst also harming the environment. Furthermore, the benefits accrue mainly to middle- and higher- income groups, while their costs are borne by the whole population[92]. Developing and emerging economies could save up to US$548 billion a year by cutting their subsidies for fossil fuel consumption; and in Saudi Arabia, Iran, Indonesia, Venezuela and Egypt, fossil fuel subsidies far outstrip public expenditure on health[93].

The current low oil price offers a significant opportunity to draw down these subsidies. Despite the economic, social and environmental case, developing countries have found it notoriously difficult – principally because of popular opposition, as shown in Nigeria, Indonesia and Malaysia in recent times. With oil prices low, there is currently a window for reform during which the adjustment cost for consumers will be lower[94]. Now is the time for governments to act, and in doing so release revenues for spending elsewhere.

CASE STUDY: Indonesia frees up billions for longer term development[95]

Like many developing countries, Indonesia has long subsidized the cost of energy ostensibly as a way of supporting poorer household incomes. By 2003 Indonesia spent around 20% of its budget on subsidies, which exceeded the sum of government spending on social programs and capital expenditures combined – but these were not reaching the majority of the poorest households. From 2005 onwards, the government has tried to liberalise fuel subsidies while at the same time launching welfare programmes to reduce the impact on the poor such as cash transfers, an expansion of the Poor Student Education Support programme, free health care and a subsidised rice programme. But progress was faltering due to the risk of a public backlash.

After four decades, the opportunity to deregulate gasoline prices came in early 2015 when oil prices dropped dramatically - from $115 a barrel in June 2014 to $50 a barrel the following January. President Joko Widodo's argument for removing fuel subsidies—that Indonesia needs the savings to fund infrastructure, education, and public health instead—found a more receptive audience as the market price for gasoline fell below its previously subsidized price. The government abolished its gasoline subsidy and reduced its diesel subsidy to just 1,000 rupiah (8 US cents) per litre. This will cut the expected government cost of subsidies to just 1% of total expenditures from a previously estimated 13.5%, freeing up $20 billion for spending in other areas.

B.3 Tax transparency: Country-by-Country Reporting

One of the most immediate BEPS-related actions for multinational companies is country-by-country reporting (Action 13): breaking down their revenues, profits and taxes for each country, rather than sweeping them into global or regional figures. According to multilateral agreement [96], companies with global revenues of more than €750 million (or the equivalent in local currency) should already be compiling a country-by-country reporting template for fiscal years beginning in 2016, with submissions to tax authorities beginning in 2017. This means that tax authorities could begin exchanging the first country-by-country reports as early as 2018 —creating unprecedented visibility into companies' tax footprints.

[92] Whitley S., and van der Burt, L. (2015), 'Fossil Fuel Subsidy Reform: From Rhetoric to Reality', Working Paper, The New Climate Economy.
[93] Ibid.
[94] Beines K., Cheon A., and Urpelainen J., (2016), 'Low oil prices: An opportunity for fuel subsidy reform', International Growth Centre
[95] Beines K., Cheon A., and Urpelainen J., (2016), 'Low oil prices: An opportunity for fuel subsidy reform', International Growth Centre
[96] As of February 2016, 31 countries, but notably not the US, have signed the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports.

While the OECD BEPS framework on country by country reporting provides data for tax authorities, there is a much broader and more persistent call from investors, civil society and the media that such data should be available to the public. This could allow for public scrutiny of the effectiveness of tax policy, reduce corruption and (as a secondary benefit) act as a deterrent to corporate malpractice[97],

This would build on the success of existing transparency projects such as the Extractive Industries Transparency Initiative (EITI) and the more recent Open Contracting Partnership (OCP). Both seek to increase transparency in government's dealings with business primarily in order to reduce corruption. They provide data that allows citizens, parliamentarians, the media and civil society to hold government to account, and as such their success is dependent on these constituencies ability and willingness to fulfill this function[99]. Nevertheless, case studies demonstrate significant benefits in terms of reduced corruption in some countries[100] (with the potential to increase economic growth[101]), and there are also indications of increased tax revenue (see box).

To be most effective, public country by country reporting of tax payments would need to be accompanied by transparency in the relevant countries' tax schedules – something that is often lacking, and which we consider in section 4A.2. This would also mitigate some business concerns with the reputational risk associated with public reporting, by revealing where businesses had kept within the spirit of the law, but faced a poor tax framework.

The importance of transparency in tax affairs is increasingly accepted[102], and a raft of other frameworks including the Capital Requirements Directive IV, EU Accounting Directive, Dodd Frank Act and the Dow Jones Sustainability Index tax criteria are together pushing a new era of tax transparency. As such, it seems reasonable to require some level of public country-by-country reporting – and the EU and others are already moving in this direction. A number of businesses are ahead of the curve: a recent survey of FTSE 100 companies showed that more than half now disclose information voluntarily about their approach to tax, up from just 32 in 2012. That trend is set to continue as companies start to manage their reputational and financial risk portfolio by moving tax into the core company reporting requirements.

CASE STUDY: Nigeria uncovers missing billions[98]

After decades of military rule and no public scrutiny of the revenues generated by the extractive sectors, Nigeria was ranked in the bottom two on Transparency International's Perceptions of Corruption Index every year between 1999 and 2004. Meanwhile over half of Nigerians citizens were living in poverty. In 2004, the then-President Olusegun Obasanjo launched the Nigerian Extractive Industries Initiative and became the first African country to pursue the EITI standard. A series of comprehensive audits across the oil and gas industries identified a missing US$560 million in tax and Nigeria has gone on to make reporting of payments by all extractive companies and revenues received by government legally binding. By 2010, Nigeria had climbed 34 places on the Perceptions of Corruption Index.

B.4 Tax transparency: beneficial ownership

In the wake of the Panama Papers leak, the drive for greater transparency regarding the beneficial ownership[103] of anonymous companies (also known as shell or conduit companies) is gaining momentum. Greater transparency would make it more difficult to use these companies to facilitate illicit financial flows, including those related to tax evasion and corruption.

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[97] Hearson M. (2014), 'Tax motivated illicit financial flows: A guide for development practitioners', Anti-Corruption Resource Centre
[98] Adapted from EITI Case Study 20.01.12: 'Nigeria EITI: Making transparency count, uncovering billions'. https://eiti.org/files/Case%20Study%20-%20EITI%20in%20Nigeria.pdf
[99] Acosta A. 'The impact and effectiveness of accountability and transparency initiatives: the governance of natural resources', Institute for Development Studies, paper commissioned by DFID.
[100] Acosta A. 'The impact and effectiveness of accountability and transparency initiatives: the governance of natural resources', Institute for Development Studies, paper commissioned by DFID.
[101] Corrigan C., (2016), 'The effect of increased revenue transparency in the extractives sector on economic growth', University of Pittsburgh, commissioned by ONE.
[102] OECD (2008), 'Tax Incentives for Investment - A Global Perspective: Experiences in MENA and Non-MENA countries' in 'Making reforms succeed: moving forward with the MENA investment policy agenda', OECD Publishing.
[103] The beneficial owner is the ultimate recipient of the benefits (e.g. dividends) related to company ownership. It excludes conduit companies, nominees etc.

Opacity in this area damages legitimate business interests. According the B20 group of business leaders – who have publicly called for greater transparency in beneficial ownership – the corruption facilitated by the status quo adds 10% to the costs of doing business globally[104]. In particular, it prevents the best companies winning government contracts and makes it much harder to know exactly with whom you are doing business, with associated increases in due diligence costs, financial exposure and the risk of litigation.

The issue has been on the international agenda for some time. The international standards set by the Financial Action Task Force (FATF) – requiring countries to ensure that the necessary authorities have access to information on beneficial ownership – have been endorsed by more than 180 countries and were last updated in 2012. Since then both the G8 and G20 have reiterated this basic FATF requirement and also suggested two ways in which it could be achieved: requiring incorporation agents verify beneficial ownership, and maintaining public registries of this information[105]. Following the Anti-Corruption Summit in London in May 2016, 29 countries are now committed to exchanging beneficial ownership information, and six will publish public registries.

Despite this progress at the policy level however, there is strong evidence that the problem lies as much with implementation and enforcement as with policy design. In a comprehensive study carried out in 2012 – where the authors asked incorporation agents in 182 countries to form a company for them – almost half of the agents failed to ask for the proper documents and almost a quarter didn't ask for any documents at all, flouting national laws[106]. Strikingly, incorporation agents in OECD countries were much more lax than their counterparts in either developing countries or tax havens. A significant part of the problem here appears to be that OECD countries are unlikely to face sanction (through blacklisting for example), in the way that smaller countries do.

Comprehensively tackling the problem of illicit financial flows will require a much more concerted effort to design loophole-free policies (requiring incorporation agents to verify their clients beneficial ownership, holding them liable for the accuracy of this information, and potentially also publishing verified[107] public registries) and more stringent enforcement regimes.

B.5 Removing the Capital Gains Tax exemption for inherited assets

One of the most common exemptions to CGT around the world is the case of inherited assets (even where no specific inheritance tax exists). This exemption is expensive (for example, costing the UK £690m in 2011/11[108]), creates perverse incentives for individuals to hold assets until death, and has no basis in economic theory. Furthermore, because many inherited assets are tangible in nature (such as property), this reform would potentially help shift the burden of taxation away from areas troubled by international mobility.

The Mirrlees Review[109] argued in favour of taxing wealth transfers on the basis of progressivity, adding that the disincentive to saving would be minimal, whilst the added incentive to work (for the recipient generation) could be significant. The UK's Institute of Directors and others have also recommended removing the exemption[110]. It would be a clear step towards increased equity.

C. Reforms that require further research or a wider package of measures

C.1 Fundamental Reform of the basis for corporate income taxes

[104] The B Team (2015), 'Ending anonymous companies', The B Team.
[105] Sharman J. (2016), 'Solving the beneficial ownership conundrum', Report for Jersey Finance, based on research funded by the Australian and Norwegian Research Councils, the World Bank and UN.
[106] See The Economist (2012), 'Launderers Anonymous', accessible at http://www.economist.com/node/21563286; based on Findley M., Nielson D. and Sharman J., (2012), 'Global shell games: testing money launderers' and terrorist financiers' access to shell companies'.
[107] Many proposals for public registries – such as that in the UK – do not require the verification of the information that they contain. Sharman J. (2016), *op. cit.*
[108] P364, Mirlees *et al* (2011), *op. cit.*
[109] Mirlees *et al* (2011), *op. cit.*
[110] Baron R. (2007), 'Capital gains tax and inheritance tax', Institute of Directors Policy Paper

In the long-term, there is growing consensus that more fundamental reform of the existing system of corporate profits taxation might be required. According to the EC's Expert Committee on the topic, *"[since] IP whose value is created within highly integrated groups [is likely to] be more and more the rule… it is therefore appropriate to raise the question how long transfer pricing rules based on the arm's length principle can be relied upon…*"[111]

This could mean, for example, taxing corporate profits in the jurisdiction of final sales to consumers (a destination-based tax[112]) or apportioning profits between jurisdictions based on a transparent formula of their observable assets (a unitary tax)[113]. The latter is already used to apportion profits between some US states, and has also recently been proposed by the European Commission for the EU. However, the former would be a more neutral form of taxation, in the sense that it would not affect incentives for insourcing versus outsourcing, or decisions regarding the location of production.[114]

More effort should be put into researching the feasibility and desirability of these two alternatives. This should be a major international research agenda, and it is currently not being given the profile that it deserves.

C.2 Reduce bias towards debt over equity finance

One particular element of corporate income taxation sometimes cited as contributing to the problem of short-termism[115], as well as resulting in excessive leverage, is the preferential tax treatment of debt over equity finance. This bias arises from the tax deductibility of interest payments, and correcting it – as part of a package to encourage equity investors to take a long-view – could help drive greater corporate long-termism.

Two obvious options for reform exist – abolishing interest rate deductibility or introducing a similar form of deductibility for equity finance[116]. The former would be hard to achieve because of both implementation challenges and arbitrage possibilities, but interest rate deductibility could be restricted (many countries are already taking this route to prevent borrowing being used to lower tax payments[117]). The second option, the allowance for corporate equity (ACE), has a strong basis in economic theory[118] and has been tried in a number of contexts[119]. It can be costly (an estimate of around a quarter of corporate tax receipts is probably reasonable[120]), but in developed countries its introduction is potentially preferable to reductions in the headline rate of corporate income taxes.

It is also worth noting that one instrument will never be able to fully address the problem of short-termism, which instead requires a package of measures that goes far beyond corporate tax policy, and focuses in particular on the regulatory framework for institutional investors, high frequency traders and others (a framework which could include targeted taxes). These topics are beyond the scope of this paper.

C.3 Tapering Capital Gains according to holding period

There is a case for using CGT to send a signal regarding long-termism, particularly in relation to equity investments. Taken alongside reforms to corporate income tax that rebalance incentives for

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[111] Page 49, European Commission High Level Expert Group on Taxation of the Digitial Economy (2014), Final Report, European Commission
[112] Mirlees *et al* (2011), *op. cit.*
[113] European Commission High Level Expert Group on Taxation of the Digital Economy (2014), *op. cit.*
[114] House of Lords Select Committee on Economic Affairs (2013), 'Tackling corporate tax avoidance in a global economy: is a new approach needed?'
[115] Della Croce R., Stuewart F. Yermo J. (2011), 'Promoting longer-term investment by institutional investors', *OECD Journal: Financial Market Trends*, Volume 2011 Issue 1 and Cox G. (2015), 'Overcoming short-termism within British business', Independent report commissioned by Labour Party.
[116] Mooij R., 'Tax biases to debt finance', IMF Staff Discussion Note SDN/11/11
[117] Mirlees *et al* (2011), *op. cit.*
[118] Mirlees *et al* (2011), *op. cit.*
[119] Klemm A. (2006), 'Allowances for corporate equity in practice', IMF Working Paper; and Zangari E., (2014), 'Addressing the debt bias: a comparison between the Belgian and Italian ACE systems', European Commission Taxation Working Paper Number 44-2014
[120] Mirlees *et al* (2011), *op. cit.;* Zangari E., (2014), *op. cit.*

issuing equity versus debt, and improvements to the regulatory regime for institutional investors[121], such a reform could help underpin greater long termism in the corporate world. This would potentially justify the departure from simplicity required.

In particular, we suggest that a simple taper to the tax rate (based on holding period) that applies to capital gains from equity would be advantageous. Larry Fink, CEO of the world's largest investment management firm has advocated a similar reform[122], as have a number of others including the UK's Institute of Directors[123]. The UK's previous experience with a taper shows that such a system is possible, although it can be expensive, and subject to abuse[124]. For this reason, we suggest limiting the taper to gains on equity investments.

C.4 Aligning capital gains and income tax rates

In many countries, capital gains taxes are subject to significant loopholes and discrepancies. The most important is the divergence between CGT and income tax rates, which creates perverse incentives to transform earned income into capital gains[125], and undermines the progressivity of the tax system[126]. For example, when Warren Buffet asserted that he faced a lower tax rate than his secretary, he was principally pointing to the fact that under the US system, income through capital gains is taxed less than salaried earnings[127].

Although we recommend tapering capital gains taxes on equity, we also follow the Institute for Fiscal Studies and others in advocating much greater overall alignment between CGT rates and income tax[128].

5. Conclusion

This paper traverses a broad cross-section of tax policy. The analysis and examples of reform we describe demonstrate that existing tax systems could be much better aligned with the SDGs. In particular, they could raise more revenue (in developing countries), send stronger signals to investors regarding desirable and undesirable activities, and better address the equity concerns arising from new models of business practice.

There are viable options for reform, many of them win-win. Four examples stand out:

- Shifting the burden of taxation onto environmental bads, in order to dramatically reduce pollution (and associated ill health), stimulate sunrise industries and generate revenue.
- Simplifying investment incentives in developing countries, and in particular, making them subject to parliamentary approval and due process. This would reduce tax uncertainty for investors, and in several countries has increased investment and tax revenue at the same time.
- Introducing greater transparency over ownership of shell companies and corporate tax payments, in order to reduce corruption (a major cost of doing business in many countries) and tax evasion, benefiting law-abiding companies and national treasuries.
- Placing greater emphasis on property taxes, which can incentivise productive use of land, clarify tenure in informal settlements, and raise revenue in a highly progressive manner.

In all of these areas, there are clear opportunities for those businesses that engage in the policy debate. Social attitudes to tax are shifting, and tax systems have yet to catch up. The gap this has created between legal systems and social attitudes has made tax a normative issue where the cost of a misstep for business can be significant. However, it has also created an opportunity for tax reform that could be harnessed to help achieve the ambitions of the Sustainable Development Goals.

[121] Della Croce R., Stuewart F. Yermo J. (2011*), op. cit.*
[122] See Larry Fink's letter to S&P500 CEO's (available at http://uk.businessinsider.com/blackrock-ceo-larry-fink-letter-to-sp-500-ceos-2016-2?r=US&IR=T)
[123] Baron R. (2007), 'Capital gains tax and inheritance tax', Institute of Directors Policy Paper
[124] Seely A., (2016), 'Capital gains tax: recent developments', House of Commons Briefing Paper
[125] Page 109, Mirlees *et al* (2011), *op. cit.*
[126] Adam S. (2008), 'Capital Gains Tax', in the Institute for Fiscal Studies Green Budget, 2008.
[127] See for example, http://money.cnn.com/2013/03/04/news/economy/buffett-secretary-taxes/
[128] Adam S. (2008), 'Capital Gains Tax', in the Institute for Fiscal Studies Green Budget, 2008.