DOI: 10.24387/CI.2023.SPECIAL ISSUE.10

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Taxation as a Crucial Part of ESG Conversation

Summary

Environmental protection has become a mainstream topic, because of the destructive effects of industrial and economic development, and many nations, international organizations have made fundamental steps in order to ensure our sustainable future. We observe a growing interaction between sustainability, ESG factors and fiscal policy. The objective of this research is to demonstrate how ESG and taxation intersect, with a particular emphasis on the developed criteria for transparency.

Keywords: Fenntarthatóság, Sustainability, ESG, Taxation, Tax evasion, Transparency
Jel codes: K34

Introduction

Addressing and mitigating climate change has become a public objective in the 20th century. Therefore, one could misconceive that the promotion of sustainability as a recently emerged topic. Nevertheless, the impact of humanity on the environment dates back over ten thousand years. Research by British archaeologist Grahame Clark has revealed a significant relationship between climate change and societal culture. Even in premodern civilizations, adaptation to local ecological conditions influenced human behaviour. According to Clark, adaptability to diverse situations has been pivotal to human evolution. (Clark, 1975).

Studies conducted in recent times provide evidence of long-lasting global impacts that are the result of historical changes in land use that span over three millennia. Even though sustainability is now a mainstream theme in modern public policy discussions and a new impulse within contemporary financial and fiscal thinking, its fundamental principles were already explained by Hans Carl von Carlowitz. He explained them in his book „Sylvicultura Oeconomica" in 1713 while supervising the Royal Mining Office of the Kingdom of Saxony. Even before the conceptual framework of sustainability was formally established in the 18th century, societies had already developed it as an essential aspect of their cultural and religious traditions. The extended success that the Egyptian and Mayan civilizations achieved over thousands of years highlights the significance of this concept.

The recognition of the detrimental effects of climate change, which are progressively worsening, has led to an increased focus on sustainability. In 1987, the UN World Commission on Environment and Development proposed the concept. Under the framework of the UN the Brundtland Commission put forward this recommendation, which is published in the document entitled ‚Our Common Future'. The idea of sustainability is rooted in the responsible utilisation and equitable distribution of the Earth's finite resources, to achieve a balance between economic development and the protection of social and ecological equilibrium. The principles of sustainable development recognise a holistic approach that encompasses environmental conservation, social prerequisites, and economic advancement.

Legislative efforts to promote sustainability began less than five decades ago, with a focus on encouraging voluntary compliance through "soft law" or similar standards on a global scale. This included non-binding conventions and recommendations formulated within the United Nations and other international bodies, as well as the European Union as a supranational entity. These documents primarily outlined strategic objectives, while the specifics of their implementation were left to individual member states. This approach gave national governments autonomy to choose their legal and economic instruments, and to determine the fiscal, legal, and temporal aspects of implementation. At that point, international institutions saw these soft law principles as catalysts for shaping approaches, with the expectation that they would be assimilated into national legal frameworks over time. The subsequent stage of this process has resulted in the development of various strategies, programs, initiatives, and non-binding guidelines by numerous nations, international organizations, and the European Union. More recently, there has been a shift towards the creation of legally-binding documents aimed at promoting environmental compliance throughout this journey.

Methodology

My research inquiry focuses on the intersection between ESG considerations and taxation, with a specific emphasis on the role of transparency within this relationship. I intend to conduct a comparative analysis of ESG and tax, exploring the chronological overlap and co-evolution of these two factors. Subsequently, I will delve deeper into uncovering the impact of ESG principles on tax transparency and draw the results. To bolster my research, I will utilize data from sources such as the OECD and European Union databases. Additionally, I will engage with pertinent financial literature to further investigate the interconnection between these two domains.

Interaction Between ESG and Taxation

During the 2000s, the development of ESG principles was a significant part of the environmental policy progression. ESG is an acronym that stands for „environmental," „social," and „governance." ESG has gained widespread recognition as a reporting framework, but its origin was as a tool for investors. The first references to ESG concerns were made in the 2006 United Nations Principles for Responsible Investment, which included the Freshfield report and the collaborative initiative titled

Who Cares Wins. This initiative, which was made up of financial institutions convened by the United Nations, was a seminal milestone as it was the first attempt to integrate ESG criteria into corporate financial evaluations. Since then, the trajectory of ESG has been characterized by continued expansion and diversification. (Bujtár, 2022). Prominent institutional investors, whose role in advocating for environmental, social, and governance considerations is pivotal, have consistently elevated their expectations of corporate behavior over the years (Bujtár, 2021).

In recent decades, it has become increasingly clear that the main priority of multinational corporations worldwide is to maximise their management bonuses and shareholder dividends. Comparatively little consideration has been given to assessing how their efforts to maximise profits affect society and the environment. The economic crisis of 2008 catalysed some changes in this situation, as the public's focus shifted towards the harmful practices of multinational companies. Tax optimization is a defining aspect of their business practices. Due to their cross-border operations, these corporations are in a continuous pursuit of opportunities to maximize profits at minimum cost in different countries through global transactions. Nevertheless, their attempts to reduce their tax liabilities inflict significant harm on national budgets. Their continuous use of the Earth's resources without fair compensation and equal contribution towards common needs is inadequate.

The exposure of financial wrongdoing and offshore practices in Panama Papers, Paradise Papers, and Luxembourg Leaks corroborates these observations, extending their relevance not only to corporations but to the wealthiest individuals as well. The arrival of the COVID-19 pandemic in March 2020 emphasized the urgency for companies to adopt a responsible approach, amidst the concomitant reduction in tax revenues and increased central budget allocations. The situation is further aggravated by the energy crisis resulting from the escalation of the Russian-Ukrainian conflict in 2022. The latest report from the Tax Justice Network, published in 2023, employs the OECD's extensive country-level data and projects worldwide tax losses to be $472 billion annually. Most of the tax evasion is linked to corporate profits.

In recent years, several international organisations have developed programmes specifically aimed at combating aggressive tax planning practices or strategies (Montenegro. 2021). The OECD has played a significant part in tackling tax evasion and the hidden economy over the years. In 2013, the Tax Base Erosion and Profit Shifting Project (BEPS) was introduced by the OECD to evaluate the worldwide structure of international taxation. Instances of fraudulent tax activities, offshore controversies, and the accumulation of wealth by multinational corporations have heightened the need for stronger measures. This has resulted in the creation of the BEPS 2.0 initiative, which expands on the existing effort. This initiative involves developing a new two-part strategy to work with over 143 countries and jurisdictions to reform international tax regulations and ensure multinational enterprises comply with their tax obligations, regardless of where they operate.

The strategy addresses various concerns associated with aggressive tax practices. In this context, the OECD takes a crucial role in advocating for different initiatives, such as improving tax transparency, which is significant concerning environmental, social, and governance issues. As the effects of climate change become more apparent, regulators, consumers, and employees expect companies to manage not only financial assets well but also to practice responsible management of natural and social resources. Achieving this requires maintaining the appropriate governance standards, integral to which transparency is as a fundamental component. Transparency includes not just disclosing the tax planning strategies that underlie corporate financial decisions but also acknowledging that these methods have caused significant harm and abuse in numerous instances in recent years. Therefore, the taxation domain intersects with ESG issues, notably through increased scrutiny of corporate tax practices. (Corwin – McNeill – Weawer, 2021).

The extent of tax payment can be regarded as a gauge of a company's commitment to corporate social responsibility (Ogachi – Zéman, 2020) (CSR), a concept discussed in scholarly literature as a dedication of businesses to ethical operations and contributions to economic progress. This commitment involves enhancing the lives of employees and their families, as well as benefiting the local community and society at large (Holme – Watts, 2000). CSR contrasts with corporate governance (Kecskés, 2011, Tóth – Zéman – Túróczi – Kása – Popp – Oláh, 2021), as the latter primarily concentrates on internal company operations, while CSR emphasizes external impacts and how a company employs its resources to enhance community well-being. CSR is intertwined with the social facet of ESG considerations. Therefore, it can be used as a measure of sustainability, as companies are expected to behave responsibly in line with corporate policies, including governance practices, ethical codes, and tax decisions. As a response to this, companies are developing more sophisticated and comprehensive tax guidelines that align with their broader ESG objectives. This has become a crucial factor in obtaining the ‚social license' to operate, which has become increasingly important for shareholders, investors and stakeholder groups. The previously mentioned elements have a strong connection with the social and governance components of the ESG framework. However, the environmental aspect is where the most tangible overlaps with taxation can be observed. This is due to the increasing use of environmental or eco-taxes by governments as a means of encouraging or discouraging activities that cause environmental harm. The following section presents an outline of the global regulations that pertain to transparent taxation.

Results – the Rise of Transparency

The relationship between ESG criteria and taxation is evident in the transparency criteria that companies are required to comply with. As a response to events such as the 2008 financial crisis, profit shifting and aggressive tax strategies, the European Union introduced the Directive on Administrative Cooperation (DAC) in 2011. The purpose of the directive was to mitigate the practice of tax avoidance. Instead of focusing solely on increasing tax rates, the emphasis shifted to ensuring revenue transparency and facilitating the exchange of information related to taxation at a global scale. The most recent regulations, DAC 7 and DAC 8, are currently being implemented into national legislation to aid Member States in managing the

impacts that arise from the digital transformation of the economy. DAC 8 has been introduced to address challenges associated with blockchain technology, including its implications for taxation. (Zéman, 2021, Szilovics, 2021). In light of this, the directive outlines guidelines regarding the reporting and automated sharing of details about earnings from cryptoasset transactions and the imposition of tax evaluations based on certain conditions for high-net-worth individuals.

In 2014, in response to the G20's call, the OECD introduced a Common Reporting Standard (CRS). This system facilitates the automatic exchange of information, obliging jurisdictions to obtain data annually from their financial institutions and tax authorities. The emphasis of CRS lies in the significance of collaboration between tax authorities, essential for countering tax evasion and maintaining the credibility of tax frameworks.

Within the BEPS initiative, the OECD has formulated an additional reporting regulation. This mandates significant multinational corporations to create a country-by-country (CbC) report. This report offers summarized information on how income, profits, taxes paid, and economic engagement are spread globally across the various tax jurisdictions where the corporation conducts its operations. Afterward, the CbC report is submitted to the tax authorities of the respective jurisdictions, aiding in comprehensive assessments of transfer pricing and risks related to BEPS. Several countries, including the European Union, have attempted to modify the CbC report's creation approach. The objective is to make the data on the involved parties available not only to tax authorities but also to the general public. In 2021, the European Union institutions unanimously agreed upon a directive for public country-by-country reporting, commonly referred to as the Public CbCR Directive. The approved amendment also requires multinational groups with a total revenue of €750 million to submit a report if they are associated with an EU parent company or have EU subsidiaries/branches of a specified size. The report must provide information about all group members, including those outside the EU. It should outline their tax practices and operations. This Directive may start implementation in Member States from June 2023.

In addition to these requirements, the growing demand for improved tax transparency from non-governmental organizations (NGOs), investors, and the general public has resulted in more promising results. The Global Reporting Initiative (GRI), established in 1997, is an autonomous international organization that helps companies take responsibility for their environmental impacts. It provides guidance for disclosing tax and financial information publicly. GRI207, introduced in 2019, is a voluntary standard that was influenced by the OECD's regulations on reporting financial information on a country-by-country basis. The purpose of this standard is to assist companies in understanding and expressing their tax governance strategies, in addition to reporting on their tax earnings and business activities across different countries. The GRI207 standard sheds light on a company's tax practices in various jurisdictions. The report may cover topics such as the organization's tax principles, tax planning methodologies, engagement with tax havens, level of risk tolerance, and approach to interacting with tax authorities. The standard provides insights into a company's tax-related actions, thus contributing to the broader objectives of tax transparency and accountability.

Conclusion

Publicly listed companies situated at the apex of financial and capital markets were primarily impacted by the introduction of ESG regulations. The ambiguity of soft law provisions resulted in relatively low adherence to sustainable development criteria, presenting challenges to these companies. The voluntary alignment was further complicated due to the diverse financial cultures of different countries, which are shaped by their distinct historical, economic, and geographic contexts. This diversity has led to innovative interpretations of environmental regulations. Governments and multinational firms, with different levels of dedication to sustainability, have demonstrated adaptability when regulations are unclear. Corporations approach their sustainability responsibilities considering factors such as their core values, financial condition, ownership expectations, and other relevant interests. Therefore, although certain companies reject even detrimental tax strategies in favour of ethical practices, many entities intentionally exploit the positive public perception of environmental consciousness. These entities attempt to project a „green" image through deceptive actions and attention-grabbing marketing endeavours, while neglecting genuine efforts towards climate protection.

One noteworthy trend is the increasing number of companies that regularly publish accurate reports on their ESG activities. This change can be attributed to higher expectations from consumers and the resulting legal requirements that have surfaced in recent years. These reports have expanded to cover essential business practices, such as tax strategies. Enhanced transparency has a positive influence on tax compliance. However, the creativity of tax strategists and evolving regulatory complexity, compounded by limited financial literacy, could impede comprehensive understanding of the tax optimization methods employed by multinational corporations in the future. To address this challenge, incorporating the concept of sustainability into financial education is recommended. Furthermore, giving greater attention to taxation in foundational financial literacy programmes could also have a substantial impact. Green tax revenues should be used prudently by central budgets and allocated towards activities that promote sustainable development goals. This can be achieved by providing public subsidies to support various green projects and investments or finance research and development that leads to improved use of alternative energies. It is important to remember that tax liability includes not only paying tax but also places a heavy administrative compliance burden on taxpayers in many cases. For this reason, transparency requirements for tax strategies and eco-tax filing should be designed to keep compliance costs within reasonable limits.

„SUPPORTED BY THE ÚNKP-22-3-II-PTE-1703
NEW NATIONAL EXCELLENCE PROGRAM
OF THE MINISTRY FOR INNOVATION
AND TECHNOLOGY FROM THE SOURCE
OF THE NATIONAL RESEARCH, DEVELOPMENT
AND INNOVATION FUND."

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