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SUSTAINABILITY IN FINANCE

Sustainability has received more and more attention over the past years and its environmental, social and governance (hereinafter ESG) factors even more so. The theme has long passed the stage of being just about the environment or the climate. The term ESG has a very wide scope. It encompasses an extensive range of considerations, including tax. Major international organizations have recognized the role that taxation could play in achieving the United Nations Sustainable Development Goals. Contributing their fair share to public revenue has become a reputational risk, especially to multinational businesses. Through the lens of ESG factors, aggressive tax optimization and harmful tax strategies are against the sustainable future. In order to give a more realistic view of how the interaction of ESG and taxation can promote economic sustainability, this paper explores the following issues. The fundamentals of ESG in finance underline the emerging role of transparency in taxation by analysing the adopted measures in the reporting frameworks around the globe. The article examines the Balkan region by highlighting and comparing the completed ESG specialised tax measures in Serbia, Croatia and Hungary.

Keywords: Sustainability, ESG, Taxation, Tax compliance, Tax evasion.

1. INTRODUCTION

The concept of sustainable development was described for the first time in 1987 when a group of experts from the World Commission on Environment and Development (hereinafter: Brundtland Commission) adopted a recommendation on environmental sustainability, entitled "Our Common Future." The document issued by the United Nations described sustainable development „as a development which meets the needs of the present without compromising the ability of future generations to meet their own needs".[1] In Rio de Janeiro, in 2012, Member States adopted the outcome document "The Future We Want" in which they decided, inter alia, to launch a process of developing a set of Sustainable

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[1] Report of the World Commission on Environment and Development 1987. *Our Common Future*. Available at: https://sustainabledevelopment.un.org/content/documents/5987our-common-future.pdf (07. 8. 2022.).

Development Goals (hereinafter SDGs) to build upon the Millennium Development Goals and to establish the United Nations High-level Political Forum on Sustainable Development. In 2015, the 193 Member States of the United Nations at the General Assembly began the negotiation procedure on the post-2015 development agenda. The process culminated in the subsequent adoption of the 2030 Agenda for Sustainable Development, with 17 SDGs at its core. The Agenda 2030 seeks to achieve sustainable development in its three dimensions – economic, social and environmental – in a balanced and integrated manner.[2]

The promotion of ESG factors is a fundamental part of the mentioned concept. ESG issues were first mentioned in the 2006 United Nations' Principles for Responsible Investment (hereinafter PRI) report consisting of the Freshfield Report[3] and a joint initiative called "Who Cares Wins"[4] of financial institutions at the invitation of the United Nations.[5] That was the first time that ESG criteria were required to be incorporated in the financial evaluations of companies. Since then, the emphasis and the scope on ESG is increasingly growing and broadening (Bujtár, 2022, p. 6). Major institutional investors playing a key role in promoting the environmental, governmental and social criteria have been raising higher compliance expectations towards companies for years (Bujtár, 2021, p. 145). Taking the process further, international organisations and countries are establishing strategies, programmes, initiatives, soft law recommendations and promulgating binding rules in order to ensure environmental compliance – inter alia – in the financial sector. With the increased focus on business practices globally, the importance of complying with tax laws in a sustainable manner has never been more important than today. The article observes a relatively new, but fundamental element of this environmental compliance by describing the sustainability aspect in taxation.

2. THE CONVERGENCE OF ESG AND TAXATION

In years gone by, businesses looked primarily to increasing shareholder returns, paying less attention to how their practices affected the environment and society. However, things have changed since the financial crisis in 2008. Public expectations about corporate tax behaviour became a mainstream topic, where there was a growing belief that undertakings were not paying their „fair share" of tax. Furthermore, the abuses exposed in the Panama papers[6], the Paradise papers[7] and the Luxembourg

[2] United Nations 2022. *Sustainable Development Goals.* Available at: https://sdgs.un.org/goals (10. 8. 2022).

[3] UNEP 2005. *Finance Initiative.* Available at: https://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf (20. 07. 2022)

[4] Demystifying ESG: Its History & Current Status 2020. Available at: https://www.forbes.com/sites/betsyatkins/2020/06/08/demystifying-esgits-history--current-status/?sh=50dcc7712cdd (03. 7. 2022).

[5] UN Environment Programme 2004. *Who Cares Wins –The Global Compact Connecting Financial Markets to a Changing World.* Available at: https://www.unepfi.org/fileadmin/events/2004/stocks/who_cares_wins_global_compact_2004.pdf (10. 7. 2022).

[6] In 2016, a German newspaper the *Süddeutsche Zeitung* released documents of a giant leak of more than 11.5 million financial and legal records, exposing a system that enables crime, corruption and wrongdoing, hidden by secretive offshore companies.

[7] The Paradise Papers are a set of over 13.4 million confidential electronic documents relating to offshore investments that were leaked to German reporters from the newspaper *Süddeutsche Zeitung*.

leaks[8] have sharpened this perception. Since early 2020, the COVID-19 pandemic has placed additional pressure on the growing importance of responsible corporate behaviour, because governments worldwide are facing shortfalls in tax revenues along with increasing social challenges (Corwin *et al*, 2021, p. 2). In recent years, several international organisations have developed programmes that are specifically designed to combat aggressive tax actions or strategies (Menez Montenegro, 2021, p. 1). The Organisation for Economic Cooperation and Development (hereinafter OECD) is at the forefront of the fight against tax evasion and shadow economy for decades. In 2013, the OECD launched the Base Erosion and Profit Shifting project (hereinafter BEPS) with the aim to revise the global international tax framework. As a continuation of this work, over 135 countries and jurisdictions created a new two-pillar plan to reform international taxation rules and ensure that multinational enterprises pay a fair share of tax wherever they operate. This project's name is BEPS 2.0. The plan addresses many issues of aggressive tax planning, including transparency, because the OECD is a catalyst for – among others – increasing tax transparency, which is a key ESG aspect.

Tax can be seen to intersect with ESG – among others - is in intensified scrutiny of corporate tax practices (Corwin *et al*, 2021, p. 2). The amount of tax paid can be seen as a measure of Corporate Social Responsibility (hereinafter CSR), which „is the continuing commitment by business to behave ethically and contribute to economic development while improving the quality of life of the workforce and their families as well as of the local community and society at large" (R.Holme & P.Watts, 2000, p. 8). CSR is different from corporate governance, because the rules of corporate governance are more concerned with the inner workings of a corporation, whereas CSR is more about „being a good corporate citizen" (Barnabás, 2020, p. 30). CSR connects to the social dimension of ESG, and thus can serve as a measure of sustainability. Taxation has another link to ESG in the governance dimension, with an expectation that companies will conduct themselves in an appropriate manner with regard to corporate policies such as corporate governance rules, code of conduct or principles governing tax choices. Regarding this, businesses are increasingly adopting and articulating clear tax principles, aligned to their broader ESG agenda. This has become a critical element in providing them with their „social licence" to operate, which is ever more important to shareholders, investors and wider communities. To sum up, we can state that tax is a key ESG metric. In the following paragraph, the article shows some promising initiatives, which are aiming to enhance transparency in relation to companies' tax practices.

3. TAX TRANSPARENCY AS A KEY FACTOR

In 2014, the OECD approved the Common Reporting Standard (hereinafter CRS) in response to the G20 request. It is an automatic exchange system, calling on jurisdictions

[8] Sometimes shortened to Lux Leaks or LuxLeaks is the name of a financial scandal revealed in 2014 by a journalistic investigation conducted by the International Consortium of Investigative Journalists. The LuxLeaks' disclosures attracted international attention and comments about tax avoidance schemes in Luxembourg and elsewhere.

to obtain information from their financial institutions on an annual basis.[9] The standard underlined that cooperation between tax administrations is critical in the fight against tax evasion and in protecting the integrity of tax systems. A key aspect of that cooperation is the exchange of information. The OECD designed another reporting rule under the BEPS project. Pursuant to it, all large multinational enterprises are required to prepare a country-by-country (hereinafter CbC) report with aggregate data on the global allocation of income, profit, taxes paid and economic activity among tax jurisdictions in which it operates. The CbC report is shared with tax administrations in these jurisdictions, for use in high-level transfer pricing and BEPS risk assessments.[10] The European Union and unilateral attempts by several countries tried to change the course of the CbC reports by pressuring the parties to let information become public. In 2021, the institutions of the European Union reached an agreement on the public country-by-country reporting directive (hereinafter public CbCR directive). Furthermore, the accepted modification will require multinational groups with a total consolidated revenue of EUR 750 million to report either whether they are EU- parented or otherwise have EU subsidiaries or branches of a certain size. The report will require information on all members of the group, including in non-EU states, about description of their tax practices and activities. The public CbCR directive entered into force on 21 December 2021, and Member States will have to transpose the Directive into national legislation by 22 June 2023.[11]

In addition to the binding and non-binding regulations, the demand for more tax transparency from non-governmental organizations, investors, and the public has led to promising achievements too.[12] The Global Reporting Initiative (hereinafter GRI) founded in 1997 is an independent international organization that helps businesses take responsibility for their impacts, by providing them guidelines on the public reporting of tax and financial data.[13] The GRI207 introduced in 2019 by the organization is a voluntary standard that builds on OECD's country-by-country reporting rules. It is designed to help a company understand and communicate its management approach in relation to tax, and to report its revenue tax and business activities on a country-by-country basis. It gives insight into the organization's tax practices in different jurisdictions. The report can include the organization's tax principles, its attitude to tax planning, can provide a view of its use of tax havens: it can also include the

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[9] OECD 2017. *Standard for Automatic Exchange of Financial Account Information in Tax Matters Second Edition.* Available at: https://www.oecd-ilibrary.org/docserver/9789264267992-en.pdf?expires=1660726067&id=id&accname=guest&checksum=1E189E434ABB7FE522E674BB72DA115E (20. 7. 2022).

[10] Action 13 Country-by-Country Reporting 2022. Available at: https://www.oecd.org/tax/beps/beps-actions/action13/ (10. 8. 2022).

[11] EU Directive 2021. EU, Decision of the European Parliament and of the Council of 24 November 2021 on amending EU Directive 2013/34 as regards disclosure of income tax information by certain undertakings and branches. L 429/13. 1. 12. 2021.

[12] EY 2021. *Tax transparency in your sustainability report (GRI 207).* Available at: https://assets.ey.com/content/dam/ey-sites/ey-com/nl_nl/topics/assurance/assurance-updates/ey-tax-transparency-in-your-sustainability-report-gri-207.pdf (15. 8. 2022).

[13] GRI 2022. *Our mission and history.* available at: https://www.globalreporting.org/about-gri/mission-history/ (12. 7. 2022).

degree of risk the organization is willing to accept, and the organization's approach to engaging with tax authorities.[14]

4. IMPLEMENTING ESG IN TAXATION IN SERBIA, CROATIA AND HUNGARY

In recent years, the Serbian Government transformed the nation's tax system to be highly conducive to foreign investment. The tax rates are among the lowest in Europe; investors can also benefit from the available tax incentives which create excellent start-up conditions. One of the key problems and challenges of the Serbian economy is the shadow economy, which primarily refers to tax evasion.[15] According to reports by international organizations and surveys of citizen opinion, the effectiveness, transparency and accountability regarding taxation need to be strengthened.[16] In order to face the mentioned issues, Serbia is undertaking an extensive legislative amendment process aimed at harmonizing its laws with those of the European Union's *acquis communautaire* and with international norms. To prevent multinational group tax avoidance and improve the resolution of cross-border tax disputes, Serbia joined the Inclusive Framework on BEPS and has pledged to adopt minimum standards on international taxation agreed to by nations in 2015 in response to the BEPS plan. These standards include adopting tougher rules, such as agreeing to collect and exchange country-by-country reports of multinationals. Serbia must agree to improve its cross-border tax dispute resolution system.[17] CbC reporting has been applied since 1 January 2020. The introduction of the reporting system means that ultimate parent entities of a multinational group resident in Serbia are required to submit a CbC report if the total consolidated revenue of the group expressed in consolidated financial statements for the preceding period is at least the RSD equivalent of EUR 750 million.[18]

ESG compliance in Croatia is still in its early phase. However, there is undoubtedly an increase in ESG investments in the country, coupled with increased requirements in corporate and investor strategies. In addition, ESG is broadening its scope of influence to cover all economic and policy sectors; tax transparency is among the impacted areas.[19] Croatia has taken its first steps in harmonising the legislation with Action 13 of the BEPS plan by introducing CbC reporting requirements. The members of multinational enterprises whose global consolidated turnover exceeded EUR 750 million in 2016 are required, for tax periods beginning 1 January 2016 or after that date, to submit to the tax authorities

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[14] GRI 207 2019. *TAX 2019.* Available at: https://www.globalreporting.org/standards/media/2482/gri-207-tax-2019.pdf (20. 7. 2022).

[15] Highlights of Serbia's Tax System 2020. Available at: https://ceelegalmatters.com/serbia/15227-highlights-of-serbia-s-tax-system (20. 7. 2022).

[16] Transparency and Accountability Initiative in Serbia 2020. Available at: https://www.worldbank.org/en/country/serbia/brief/transparency-and-accountability-initiative-in-serbia (14. 6. 2022).

[17] Serbia joins "Inclusive Framework on BEPS" to fight tax avoidance 2018. Available at: https://mnetax.com/serbia-joins-inclusive-framework-beps-fight-tax-avoidance-26149 (20. 7. 2022).

[18] Orbitax 2020. *Serbia Publishes 2020 Budget Laws Including CbC Reporting Requirements.* Available at: https://www.orbitax.com/news/archive.php/Serbia-Publishes-2020-Budget-L-40390 (14. 8. 2022).

[19] ESG Investments Croatia 2022. Available at: https://venturexchange.hr/esg-investments-croatia/ (13. 8. 2022).

their reports together with the annual corporate income tax return.[20] The country also seeks opportunities to implement the European Union's latest achievements – including e.g. the public CbCR directive – regarding the fight against tax evasion. This is very important, because the shadow economy accounts for a significant part of the GDP of Croatia.[21] Significant amounts of cash are used in the tax crime schemes.[22] The Croatian Tax Authority have stepped up their digitalisation effort since 2013, in order to create a more efficient tax administration, to reduce the use of cash, and to make communication with taxpayers more effective and transparent.[23] The digitisation of tax services and tax administration seems to be an optimal tool for reducing the size of shadow economy.

The situation is the same in Hungary, where the Government made some fundamental changes in the tax system since 2010, with the aim to face tax evasion but also international tax competition (Szilovics, 2020, p. 2). As a consequence, the Hungarian tax system is among the most favourable in Europe, due to the friendly corporate tax environment and tailor-made incentive offers, mainly for foreign investors (Szilovics, 2019, p. 2). The country is also promoting sustainable development and ESG movement in finance. However, in order to preserve its competitive status Hungary was against the latest public CbCR directive. The main reason behind the „resistance" was, that the extended reporting obligation may deter foreign companies from investing in the country and this could lead to substantial tax revenue losses for the central budget.[24] Finally, the country agreed with the Union and will implement the applicable rules in the near future.

5. FINAL THOUGHTS

The intersection between taxation, sustainability and ESG dimensions has different outlooks. In the article, the author examined the financial side by concentrating on the tax transparency matters of the topic. Public and investor demand for greater tax transparency is likely to continue to accelerate, and build upon the presented initiatives and achievements. This phenomenon clearly leads to the whitening of the shadow economy and the restriction of tax aggressive corporate behaviours. However, we must note that there are loopholes in the current system under development. The agreement on public CbCR report is restricted to the members of the European Union, which means that companies can easily shift their taxes outside the EU by methods they already use. The current tax transparency initiatives will not affect many of the tax havens. A global consensus is the only solution. Another important issue could be the growing tax compliance demands and administration costs

[20] PWC 2022. *Croatia Corporate - Group taxation.* Available at: https://taxsummaries.pwc.com/croatia/corporate/group-taxation (10. 8. 2022).

[21] More than 30% in 2016 according to the IMF and 6,97% in the same year according to the EUROSTAT.

[22] Anti-money laundering and counter-terrorist financing measures Croatia 2021. Available at: https://rm.coe.int/moneyval-2021-24-mer-hr-en/1680a56562 (18 .8. 2022).

[23] WTS Global 2019. *Croatia: Digital taxation and digital transformation.* Available at: https://wts.com/global/publishing-article/croatia-20191024~publishing-article?language=en (17. 7. 2022).

[24] Portfolio. 2021. *Összejött a fontos brüsszeli alku: a Magyarországon működő nagy multiknak is színt kell vallania.* Available at: https://www.portfolio.hu/gazdasag/20210602/osszejott-a-fontos-brusszeli-alku-a-magyarorszagon-mukodo-nagy-multiknak-is-szint-kell-vallania-486074 (10. 6. 2022)

regarding the additional reporting obligations. Who will bear these costs? The businesses or the consumers?

The three examined countries recognized the importance of ESG factors, and have already started to implement the international standards in order to face the challenges. In the author's opinion, in addition to the modification of the legal framework towards sustainability, Hungary, Croatia and Serbia need to make some changes or upgrades in their financial literacy too, with the aim of fostering increased compliance on the part of the taxpayers.

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