Is Tax Behavior a Flawed Sustainability / ESG Metric?

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1. Sustainability Metrics – an Overview

It is evident that ESG ratings are important for investors as well as for enterprises. However, it is also well-known that these ESG ratings are to a certain extent opaque and also not fully persuasive depending on the underlying benchmark. The benchmark could, on the one hand, be the sustainable development of the value of the enterprise **(business development rationale)**. On the other hand, it could also be the fulfillment of the Sustainable Development Goals (SDGs) as approved by the UN General Assembly in 2015 **(comprehensive development rationale)**.[1] In the current methodologies towards ESG ratings both approaches are mingled.

Having this in mind, the goal of this article is not to challenge ESG ratings per se as they can indeed incentivize enterprises to act in a more sustainable manner. However, as it will be outlined, these ratings can also have a detrimental impact as some of the metrics may be misused to offset bad ratings in one area with exceptionally good ratings in another area. One example are tax metrics used for ESG ratings.

2. Example to Start

To give a rather extreme example to demonstrate the validity of the argument, assume that a Russian multinational in the oil business which is close to the government has in the past years followed the available sustainability standards to a large extent. Due to this reason, its tax transparency policy has led to a result in which its «Global and Home Market Percentile Rank» by one rating agency is 100th (Best in Class). This means that the agency puts the company in the 100th percentile to its global and domestic industry competitors, inter alia, on an evaluation of possible tax controversies involved and the tax gap calculated between the estimated corporate income tax rate and the targeted effective tax rate.

1 We further outline the meaning of these terms in the following paper Peter Hongler, Florian Regli & Thomas Berndt, Tax Reporting and Sustainability, IFF-HSG Working Papers No. 2021-6, p. 1 et seq.

However, it is far from clear whether its tax behavior has done any good in the world for obvious reasons. Nevertheless, its approach towards tax behavior might have helped such a company to increase its ESG rating and even offset parts of its negative factors within the ESG rating. Therefore, if the benchmark is a comprehensive development rationale it is far from clear whether such Russian company has acted in a sustainable manner although its tax rating was presumably very good. Of course, this is a rather extreme example but it shows the underlying risks of current approaches towards ESG ratings.

3. Is Tax an Important ESG Metric?

It is evident that ESG ratings are important for investors. These ratings partly use tax behavior in its widest form as part of the overall ESG metric. Depending on the rating agency, tax might amount to up to 5% of the overall ESG rating of an MNE.[2] In addition, certain tax behaviors (such as the use of tax havens) can lead to a downgrading of the ESG rating or even an exclusion of companies from capital providers' investment decisions. It is, therefore, not a surprise that the tax section in sustainability reports has gained importance over the past years, just like the ESG rating in general.

4. What Are the Challenges in Incorporating Taxation Considerations into ESG Metrics?

Although tax seems to play an important role as an ESG metric, there are several challenges triggered by linking ESG tax metrics and development policy goals.

First, it is not at all clear how exactly tax is used as a metric for calculating the overall ESG rating of an MNE as it is unclear which assessment criteria play a crucial role for rating agencies. Their metrics used are only partly published. Moreover, there are a variety of recommendations published by different organizations (Global Reporting Initiative [GRI], Principles for Responsible Investment [PRI], World Economic Forum [WEF], OECD, etc.) in tax matters and these recommendations are a source of inspiration for the rating agencies as well. A first analysis shows that there are up to 90 different recommendations in tax matters. For instance, to name three, it is suggested that MNEs shall draft a tax strategy, that they should not bribe tax authorities but also that they should publish their approach concerning the engagement with tax authorities in general. Therefore, tax metrics used are not only hard facts such as how much taxes an enterprise pays (maybe compared to competitors) but also a variety of soft criteria to assess the overall tax behavior.

Nevertheless, the underlying narrative of tax metrics used is that higher tax payments or less tax planning is in general considered to be a good tax behavior.

This brings us to the second and most important challenge. Besides these technical challenges in defining persuasive metrics, a more fundamental issue arises as tax behavior does not necessarily have a direct effect on the SDGs (e.g. compared to prohibition of child labor or the reduction of CO2 emissions within the supply chain). This is the case as the assumption that tax payments are always good for development depends on how states invest tax revenue. Governmental investment into military forces might obviously not have the same effect as investments into health care. This is undeniable and an obvious concern. Some recommendations such as the prohibition of tax bribery, nevertheless, seem to have an unconditional positive direct impact on the development of a state.

2 However, based on our own exchanges with rating agencies, tax might on average amount to 1-3% of the overall rating.

5. Is There a Way Out?

ESG metrics are a great opportunity to achieve development policy goals through incentivizing the private sector to act in a certain manner. This is also true with respect to tax as an ESG metric.

However, badly designed ESG metrics can also be detrimental as they enable window dressing in the sense that positive tax behavior might offset a negative assessment in other areas such as environment. Badly designed and opaque ESG ratings seduce companies to do ratings management (comparable to doing earnings management) just to fulfill certain expectations without any link to real effects on the SDGs. Therefore, from a development policy perspective it is absolutely decisive that these tax metrics are well-designed. In this regard, we need a new debate about the intersection between tax behavior and sustainable development. It is key to have independent bodies judging which, if any, tax behaviors are a solid ESG metric.

From an MNE's perspective, the topic is frustrating as compliance requirements have significantly increased over the past years and it does not necessarily lead to a sustainable development of the world. Current approaches seem to mainly improve the «G» in ESG as the current recommendations such as GRI 207 tend to focus on governance factors, i.e. that tax risks are mitigated.

Of course, this is a valid approach if the goal is to assess the sustainable development of the value of the company but such recommendations can hardly be linked to the SDGs. It also means that it needs to be clarified and clearly communicated what the goal of these ratings is.

The underlying even more fundamental issues is that the more factors are included in a sustainability rating the less its informative value is regarding some of the most important and undisputed impact factors such as CO_2 emissions. Of course, there are new approaches at the horizon (incl. disclosing all taxes paid by an MNE) but even if such metric is used, it is questionable whether the payment of a tax (even of carbon taxes) is per se an effective way of achieving the SDGs.