Competitive Strategies for Corporate Sustainability

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Abstract

This is an exploratory study to gain insight among tax and Environmental, Social, and Governance (ESG) practitioners on the link between ESG and tax compliance. Prior studies used secondary data to examine the association between ESG and tax avoidance and reported inconclusive results. This leads to speculative discussions to support the results, among which are corporate ethics and corporate hypocrisy. This motivates the present study to examine the perception among involved parties to understand their views on the relationship. A total of 22 respondents representing firms, consultants, and regulators are interviewed. We found a gap between the perception of firms and tax regulators and that of consultants concerning the link between ESG and tax compliance. There is also inconsistent views among sustainability and tax personnel at firms. Interestingly, we found that only government-linked companies perceived tax compliance as part of their social responsibilities. Our study implies that there is evidence to support a negative relationship and no relationship between tax avoidance and ESG but no evidence to support corporate hypocrisy.

Keywords: tax compliance; tax avoidance; ESG

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Introduction

The present business environment demands that firms not only serve their shareholders but also other stakeholders. Pressure from stakeholders such as investors, regulators, and the public causes firms to engage in environmental, social, and governance (ESG, hereafter) initiatives (Cicchiello et al., 2023). While such pressure can be argued to be a source for firms to engage in ESG activities, prior studies have found that the act can also be tied to morality and the ethical stand of the firm (Bouzzine, Lueg, 2023; Mitnick et al., 2023) or simply a strategic business move to gain economic benefits from the customers (Hamza, Jarboui, 2020; Herremans et al., 1993).

At the same time, the ESG agenda has coincided with an increasing efforts by the Organisation of Economic Co-operation and Development (OECD, hereafter) to combat aggressive tax avoidance strategies (Fonseca, 2020). Corporate tax avoidance is also associated with unethical or immoral stances (Jenkins, Newell, 2013; Scheffer, 2013; Sikka, 2010) and a firm's pursuit of pure economic benefits for shareholders (Wang et al., 2020). With the initial publication of the OECD's guidelines on multinational enterprises[1] (MNEs, hereafter) in 2008 (revised in 2011), many countries subscribed to the idea of incorporating tax governance and tax compliance as important elements in the broader risk management system. The guidelines emphasize the need to have good internal control within a corporation that will enable them to be responsible for tax compliance. However, most countries did not make tax compliance an explicit requirement in their corporate governance legislation except for three countries – Australia, the UK, and the Netherlands (OECD, 2013).

Sikka (2010) argued that in a situation where a firm engaged in both ESG (or corporate social responsibility – CSR) and tax avoidance, the firm is displaying inconsistent ethical values or "corporate hypocrisy" as termed by Sikka (2010). Organized hypocrisy constitutes inconsistencies between action, talk (rhetoric), and decisions, which arises from an environment characterized by irreconcilable normative-ideational pressures. As such, firms with sound ethical standpoints should comply with both the letter and the spirit of the law, thus not engaging in any aggressive tax avoidance activities.

Corporate hypocrisy is a situation where a firm is not consistent in its ethical standing, where the firm attempts to portray itself as having ethical and moral values through its ESG initiatives to cover up its actual moral standard. If a firm is consistent in upholding its moral and ethical standards, the relationship between ESG and tax avoidance should be negative. Tillman et al. (2020) identified three theoretical facets of corporate hypocrisy perceptions: moral hypocrisy, behavioral hypocrisy, and hypocrisy attributions – which are derived from two sources (i) driven by firms' deceptive practices and (ii) driven by mere inconsistent behaviors.

Given the mixed results between tax avoidance and ESG as reported by prior studies (Godfrey, 2005; Godfrey et al., 2009; Jones et al., 2017; López-González et al., 2019; Ortas, Gallego-Álvarez, 2020; Yoon et al., 2021) which has only relied on secondary data sources, the main aim of this paper to evaluate the extent to which tax avoidance is associated with ESG using primary data sources within a qualitative scope and seek a better understanding of tax avoidance in relation to ESG. As such, this study will provide evidence of the concept of tax avoidance, as practiced and conceptualized by organizational actors in the taxation ecosystem within the ambit of the ESG context.

In Malaysia, the OECD MNE guidelines have been adopted and the Inland Revenue Board issued a tax corporate governance framework in April 2022. However, there is no explicit requirement in the Malaysian Corporate Governance Code. Given the implicit requirement for tax in current legislation and unsettled arguments in the literature linking ESG with tax compliance, this study attempts to explore the perception among relevant parties in the industry, including tax practitioners, ESG practitioners, consultants, and regulators as to what are the links between ESG and tax strategy (avoidance or compliance). The findings of this study will help to establish the extent to which tax compliance is perceived to be related to ESG in Malaysia. This will expose the gap that needs to be addressed by the relevant authorities to educate, enforce, and implement the necessary changes in legislation.

Literature Review

ESG

The concept of ESG was initially confined to CSR activities among firms. However, the CSR concept was further refined by the United Nations (UN) to include governance, known as ESG. In its role to promote ESG, the UN has issued the Principles of Responsible Investment (PRI)[2] report. The re-

[1] In two editions – 1st in 2008, and 2nd in 2011. https://www.oecd.org/corporate/mne/, accessed 19.06.2023.

[2] https://www.unpri.org, accessed 19.06.2023.

port recommends that investors incorporate ESG factors into their investment decisions and active ownership. This later has been embraced by governments, firms, banks, and rating agencies that had shaped the current ESG landscape in the world. ESG ratings and scores such as Global Reporting Initiative (GRI)[3] were developed, adding more pressure among firms to comply with ESG requirements. As a result, it is found that ESG reporting has been made mandatory for all publicly listed firms in some countries such as the United States, the UK, Hong Kong, Malaysia, and Singapore while most countries are making it voluntary.

Past studies have shown that most firms engaged in CSR activities to showcase their ethical stance in the eyes of the public to justify the firm's continued existence (Abdul Rahman, Alsayegh, 2021). This is consistent with stakeholder theory which views the need for a firm to consider stakeholders as individuals or groups of individuals who can affect or be affected by business activities (Freeman, 1984). There is also an argument grounded in legitimacy theory that ESG initiatives are mainly driven by firms to be legally accepted by the public (Odriozola, Baraibar-Diez, 2017). Another explanation as to why firms engage in ESG practices includes conformity to the regulations as a firm is considered a subset of society. Institutional theory considers a firm to work within a given set of values norms, and assumptions which constitute reasonable economic behavior including corporate CSR and other accounting practices to the standards and values of a society (Khan, 2022).

Tax Avoidance

The corporate tax avoidance issue has gained greater attention among tax practitioners, regulators, and researchers following several prominent firms such as Apple, Starbucks, and Google[4] getting exposed for their close to zero tax payments to the government despite earning substantial income in that particular country. This is achieved through the manipulation of legislation in multiple countries to shift income from one country to another, resulting to close to zero tax payments to the countries involved. In response to this, the OECD has launched 'Base Erosion Profit Shifting (BEPS) actions to deter and stop this aggressive tax avoidance behavior.[5] To date, the OECD has issued 15 BEPS actions including harmful tax practices (Action 5), prevention of tax treaty abuse (Action 6), and mandatory disclosure rules (Action 12). These BEPS actions receive support from countries around the world. On 11 July 2023, 138 countries including Malaysia pledged their commitment to the Inclusive Framework on BEPS, which will lead to a major reformation of the international tax system (OECD, 2023).

For Malaysia, in support of BEPS Action 12 and the OECD MNE guideline, Bursa Malaysia has introduced a requirement for tax compliance disclosure and the Malaysian Inland Revenue Board issued the Tax Corporate Governance Framework (TCGF, hereafter) in April 2022 and invited several companies to participate in piloting the implementation of the framework. Despite all attempts to combat corporate tax avoidance, it is still a rampant phenomenon (Kovermann, Velte, 2021; Thomsen, Watrin, 2018).

Prior literature has documented the lack of an ethical stance to be one of the reasons for tax avoidance behavior (Benkraiem et al., 2021). As tax payments are compulsory contributions imposed on individuals or corporations to the government, which will eventually be used for public welfare, tax avoidance is considered unethical behavior since the act, although considered legal, shows the irresponsible attitude of a firm with regard to giving back to country where it operates. The outcome of tax avoidance is low tax collection by the government, thus affecting the ability of the government to serve society (Freedman, 2003; Lanis, Richardson, 2015; Sikka, 2010). Corporate tax avoidance also differs between countries mainly due to the institutional environment in each country (Benkraiem et al., 2021). Studies have reported that corporate tax avoidance is associated with the level of a country's societal trust (Kanagaretnam et al., 2018) and a country's level of enforcement (Bruno, 2019). Societal trust is a concept that deals with mass compliance with moral rules; the extent to which a general level of trust toward others in the society exists (Kanagaretnam et al., 2018). Thus, a country-specific study is needed to understand corporate tax avoidance behavior and the extent to which this behavior is viewed within ethical stances as well as the specific attributes of a particular country.

ESG and Tax Avoidance

The earlier discussion pointed out that there are common factors to explain both ESG and corporate tax avoidance. Based on the ethical premise of a firm, previous studies expect a negative relationship between corporate social responsibility (CSR,

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[3] https://www.globalreporting.org/, accessed 19.06.2023.

[4] https://www.reuters.com/article/us-eu-tax-avoidance-idUSBRE94L0GW20130522, accessed 15.10.2023.

[5] https://www.oecd.org/tax/beps/, accesed 15.10.2023.

hereafter) and tax avoidance, where firms that engage in many CSR initiatives will also tend not to engage in tax avoidance activities. Corporate culture theory (Kreps, 1990) suggests that while most managers tend to manipulate profits to reduce the tax burden, this may not be the case for socially responsible firms. Within this theory, CSR is the belief about the "right" course of action, where a socially responsible firm considers the economic, social, environmental, and other externalized effects of corporate decisions (Yoon et al., 2021). This argument is supported by many empirical findings (Davis et al., 2016; Jones et al., 2017; López-González et al., 2019; Yoon et al., 2021).

On the contrary, some other studies found a positive relationship between ESG and tax avoidance (Godfrey, 2005; Godfrey et al., 2009; Zeng, 2019). This finding supports the argument by Sikka (2010) that firms used their ESG practices to cover up their tax avoidance behavior, displaying their inconsistent ethical stance, labeled as 'corporate hypocrisy'. This theory highlights the management of tax avoidance as a tool to enhance a firm's reputation for ESG practices while employing tax avoidance as a risk management tool concerning the firm's ESG reputation. Alternatively, Zeng (2019) argued that the relationship between ESG and tax avoidance could be positive due to the inconsistent legal and institutional environment of the relevant countries. He claims that CSR and country-level governance are substitutes in the sense that for corporations to engage in tax avoidance, weak country-level governance means a firm's CSR scores need not be high.

The third group of empirical studies found no significant relationship between ESG and tax avoidance (Davis et al., 2016; Mao, 2019). They argued that ESG and tax are independent corporate decisions. ESG managers believed that ESG practices would enhance a firm's reputation and value and enable management to avoid legal and financial complications with legislators, thus said practices would benefit the shareholders in the long run. At the same time, tax managers viewed their actions in avoiding tax as a benefit to shareholders. This is consistent with the shareholder theory discussed in Friedman (2007), where firm managers' main objective is to generate profit while reducing costs. However, the current efforts to link ESG and tax compliance led by the OECD may have inevitably forced cooperation between ESG and tax divisions within a firm.

The systematic literature review on the relationship between ESG and tax avoidance shows that all studies in this area employed a quantitative approach (Kovermann, Velte, 2021; Whait et al., 2018). Whait et al. (2018) argued that there are four main reasons for the inconsistent findings in prior research – (i) limited samples of companies within a specific country; (ii) inconsistent measures of corporate tax avoidance; (iii) inconsistent measures of CSR; and (iv) the omission of control variable related to the country-specific factors that might play a significant role in that relationship such as the national culture of countries, institutional constraints, and so on. Ortas and Gallego-Álvarez (2020) also provide additional evidence that ESG and tax avoidance are moderated by national culture. They found the relationship is more negative and stronger in cultures that are characterized by individualism, long-term orientation, and indulgence. It is less negative and weaker in cultures that are characterized by power distance, masculinity, and uncertainty avoidance. Hence, we argue that there is a need to employ a qualitative approach in a specific country to explore the link between ESG and tax avoidance. The arguments put forward by the prior studies, particularly on ethical stances, need to be further examined via a qualitative approach, which facilitates a deeper understanding as to why such a relationship exists and which motives are involved.

Methodology

This study used a qualitative approach to explore the perception of firms, consultants, and regulators concerning the link between ESG and tax avoidance. The interview method is employed. Sample firms are selected from publicly listed companies in Bursa Malaysia as of 1 June 2022. The potential interviewees were approached via email and/or LinkedIn. Specifically, the study only approaches individuals that hold designations such as Finance Manager/Financial Controller, Tax Manager, Head of the Sustainability Department, Group Chief Sustainability Officer, and any equivalent designation that assumes responsibility for the company's ESG or tax matters. The study employed snowballing sampling to increase the number of respondents including tax and ESG consultants. The authors also emailed the Inland Revenue Board to participate in this research. In total, 22 respondents were interviewed. The final respondents are presented in the Table 1 below.

The semi-structured interviews are conducted over a 10-month period during September 2022 until June 2023. Each interview runs between 45 minutes and one hour. Most of the interviews are conducted online except for one interview. Respondents are duly informed of the research objectives and were given sample questions before the interview session took place. The interviews are transcribed verbatim and analyzed.

Results

Perceptions of Publicly Listed Firms

We found that there are mixed perceptions among sustainability and tax personnel concerning the link between ESG and tax strategies. Overall, sustainability personnel at firms show limited awareness of the relationship, thus supporting the earlier studies where no relationship exists between ESG and tax avoidance (Davis et al., 2016; Mao, 2019). One of the respondents [Mr. C] considers tax compliance unavoidable and thus says itcannot be linked to ESG:

"…when you talk about tax [compliance], of course tax is an inherent business matter, right? That the company will look into, but didn't really link it to sustainability".

On the other hand, tax personnel demonstrated awareness of the relationship. Most of the tax personnel view the link between tax strategies (compliance or avoidance) as part of the governance section of ESG. They provide an understanding as to why tax strategies are part of governance as tax is indeed an obligation to pay dues to the country where a business operates. One of the respondents, [Ms. R] commented

"… if you are as an organization really in tune with the ESG commitment, then it also means about how transparent you should be when it comes to tax methods, because taxation is not just an obligation where you calculate your revenue, your expenditure, etc. and then you come up with a value to pay to a certain country…"

We also found that tax personnel understand that tax governance and tax compliance are important elements of the broader risk management system. This is consistent with the OECD guidelines for MNE (revised) – the principle of good tax governance (OECD, 2013). One of the respondents, [Ms. D] stated that:

"our tax governance, who we have, and the importance we have in terms of making sure we have people who know the tax requirements and so on so forth so that you know, at no time at all do we compromise on the policies and compliance and so forth. I think our attitude toward tax planning, management of tax risk… So this is the minimum level of assurance that we feel we should be giving to our stakeholders in terms of giving them assurance from a governance perspective.."

We also evaluated the perception of ethics and morality in paying taxes and how it can also be linked to the social part of the ESG. While these two notions may differ in a legal context, for the purpose of this study, ethics and morality are not viewed separately following Harper (2009) who emphasized that both are not to be considered as contrasting and separate, except for the fact that 'ethics' refer to the ancient view and 'morality' refer to the modern view. Consistently, the logic of linking tax compliance and the social aspect of ESG was not well received by sustainability personnel. This finding further supports the prior literature that found that there is no relationship between tax avoidance and ESG (Davis et al., 2016; Mao, 2019). The ESG personnel view tax as a mere payment to the government and not directly to the people, hence there is a possibility that the money is not managed properly for public welfare and such employees question the public accountability of the government arm in handling tax distribution effectively. One of the respondents, [Ms. A], stated:

"… as a corporate citizen, as a company, of course we need to do our obligation to pay the tax so that the government, the country can generate revenue as well. But again, if [only] they're spending wisely into a correct channel…"

The perception among tax personnel is mixed, where most respondents do not see the link between tax compliance [or avoidance] and social initiatives. However, we found the perception differs with tax personnel in government-linked companies, where the understanding of how tax payments are tied to the social aspect of ESG is clear. One of the respondents, [Ms. D] stated:

"..As a law abiding corporate, we have to make sure we do our part in [what's that]… returning back the pie back to the government and the people.."

This translates to the ethical stance of the firm, which also believes the ESG initiatives are to benefit the environment and society. This finding is consistent with previous studies that support a negative relationship between ESG and tax

Table 1. **Sample of Respondents**

Respondent	Number of organisation	Number of individuals
Public listed companies	2	2
Multinational companies	3	4
Government-linked companies	2	8
Sustainability consultant	2	2
Tax Consultant	3	3
Tax officer	1	3
Total	14	22

Source: authors.

avoidance (Davis et al., 2016; Jones et al., 2017; López-González et al., 2019; Yoon et al., 2021).

It is also apparent that there is minimal cooperation between sustainability and the tax/finance departments. We found most firms have all representatives from different departments within the firm, including finance, but the direct link with the tax department is missing. However, the cooperation is more visible within multinational firms that operate in other jurisdictions where a tax compliance agenda was introduced much earlier. One of the respondents, [Mr. E] illustrates that cooperation does exist in the firm where sustainability and tax personnel work together in ESG matters to incorporate tax into its risk management strategy:

"In this conversation [ESG], we have not just a risk management team. We have group finance, we have tax experts as well the academicians talking about the same topic [ESG]."

We argued the above finding reflects the fact that the tax compliance framework (i.e. TCGF) is in its infancy in Malaysia. As tax compliance is very technical, it is understandable that there is minimal involvement of other team members apart from tax personnel including sustainability personnel in working toward the tax compliance framework.

Perceptions of Consultants

We found both sustainability and tax consultants are aware of and understand the link between ESG and tax strategies. This finding shows that the consultants are ahead of the firms in their understanding of the incorporation of tax compliance as part of the governance and social aspects described by ESG strategies, although tax is not explicitly mentioned in the Malaysian Code of Corporate Governance. One of the respondents, [Ms. G] who is a sustainability consultant states:

"I think it's very important because I believe that … good tax governance is a subset of good corporate governance. So, for me it's very simple, you have good tax governance, it's a subset of good corporate governance. A good tax governance framework for a company helps to identify the tax risk (…) assess your risk and sets out the actions that you need to take to mitigate the impact of those tax risks. So I think an effective tax governance framework can cultivate the level of confidence that the organization is reporting and paying the right amount of tax."

One of the respondents, [Ms. S] who is a tax consultant explained:

"…when you pay tax, you are actually contributing to the government's revenue, right? And the government uses the revenue also for the social part, right? … So the public will be able to know how much taxes the company pays, and … this can go toward the social element because, taxes are in Malaysia, we all know right… more than 60% of the government's total revenue. So it is really, really important for the government to ensure that they collect the right amount of taxes, and so that the revenue then can be properly spent on … projects and the activities that the country wants".

Based on this perception, it can be concluded that there should be a negative relationship between ESG and tax avoidance, which supports the past literature (Davis et al., 2016; Jones et al., 2017; López-González et al., 2019; Yoon et al., 2021).

Perceptions of Regulators

We found the regulators believed that tax compliance is related to governance and the social part of ESG principles. The motivation for the regulator to introduce TCGF is in line with international practices, the OECD guidelines, and BEPS action plans. The emphasis was that tax transparency should be explicitly stated in the ESG and not incorporated into general governance. One of the respondents, [Mr. J] states:

"..when we relate the tax governance with the ESG is more like you ..say it about the missing T in the ESG. What is it mean by the missing T? That [is] the tax transparency."

The tax regulators also think that the link between ESG and tax compliance can be further enhanced if it is explicitly stated in the Malaysian Code of Corporate Governance (MCCG, hereafter). However, as TCGF is still in its early stages, where several companies have been selected to be under the TCGF program, the step to integrate governance and tax will be one of the agenda items in the future. Nevertheless, initial efforts to link the tax to corporate governance have been initiated. One of the respondents, [Mr. J] states:

"We did have several engagements with the respective bodies that are responsible for corporate governance. So far, we have received positive feedback for them to consider. This tax matter can also be included on the corporate governance agenda."

Conclusion

There has been a long debate in the literature about linking ESG to tax avoidance (Kovermann, Velte, 2021). Unfortunately, the results are inconsistent due to the quantitative approaches used by prior researchers (Whait et al., 2018). This study attempts to address this issue by taking a direct approach in

seeking the views held by relevant parties which includes firms, consultants, and regulators by evaluating how tax avoidance is conceptualized and understood within the ESG agenda at firms. The findings show that there is a gap in the understanding of tax avoidance and ESG practices among tax regulators and consultants. Tax regulators, sustainability consultants, and tax consultants are found to be able to link ESG and tax strategy (either in the form of compliance or avoidance) while perspectives obtained from the firms sampled in this study show inconsistent understandings of the relationship. The sustainability personnel perceived no connection between ESG and tax strategy, thus supporting some of the previous findings in the literature (Davis et al., 2016; Mao, 2019).

On the contrary, views sought from tax personnel proves that they are able to appreciate the link between tax strategy and ESG. However, they are unable to describe how this is linked with the 'environmental' and 'social' aspects of ESG, but limited only to the 'governance' part. Only tax personnel in government-linked firms demonstrate an understanding of linking tax strategy to the social part of ESG, thus supporting the idea that ESG is negatively related to tax avoidance (Davis et al., 2016; Jones et al., 2017; López-González et al., 2019; Yoon et al., 2021). A possible explanation of these may relate to the culture of these respective firms in which training and exposure of concepts of ESG engrained within these firms translated into a better understanding of these concepts.

This study also is unable to establish that ESG is being used to conceal tax avoidance behavior or corporate hypocrisy. We therefore conclude that, in the context of our study, tax avoidance and ESG concepts are not viewed to be interdependent of one another and no connections could be made between the two.

Thus, this study outlines the following implications. Firstly, more work needs to done, by everyone in the ecosystem, in educating and enhancing awareness on how tax strategy (avoidance or compliance) affect the governance and social aspects in ESG. The focus should be on strengthening awareness and understanding among sustainability personnel. Second, there is a need to explicitly mention tax compliance in MCCG as is the practice in other countries such as the UK, the Netherlands, and Australia (OECD, 2013). By incorporating tax explicitly in the MCCG, the process of educating firms can be enhanced and necessary timeframes shortened. This study acknowledges the limitation posed by the low number of respondents involved so future research should focus on increasing the number of respondents to represent firms of different sizes, industries, and countries for better insight.

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