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Tax Avoidance of State-Owned Enterprises and What Policymakers Can Do About It

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State ownership is common in many countries around the world. According to a study by the OECD, in 2011 around 10% of the 2,000 largest firms in the world were state-owned.[1] Moreover, the 2008 financial crisis and more recently the Covid-19 pandemic have led to increases in state ownership. For example, during the 2008 financial crisis, the U.S. government provided aid to struggling firms such as General Motors in return for shares. Similarly, Italy became a shareholder of the airline Air Italia as a reaction to the Covid-19 pandemic. The government equity injections during the ongoing pandemic have been highly debated, and one political demand in these discussions is to require a decrease in tax planning activities as a condition for governmental aid.[2]

STATE-OWNED ENTERPRISES ENGAGE IN TAX PLANNING REFLECTING OWNERS' INCENTIVES

Despite the commitment of national governments and international organizations to tackle harmful tax avoidance, certain state-owned enterprises (SOEs) exhibit low effective tax rates, implying that even these firms in which the government has a direct stake engage in tax planning. Anecdotal evidence includes the Dutch state railway using a so-called Dutch-Irish scheme[3] or Austrian and German municipalities that used cross-border leasing arrangements with U.S. investors.[4] Motivated by these somewhat striking anecdotes, a new study by researchers from the Vienna University of Economics and Business[5] reveals that SOEs' income tax planning activities are determined by their state-owner's incentives.

To clarify the study's underlying intuition, one has to recapture how a state-owner receives distributions from its SOE, as there are two distinct ways. First, as a shareholder, the state-owner receives its share of after-tax profit distributions. Second, as a tax collector, the state-owner can benefit from the firm's income tax payments, provided that the state-owner is actually collecting the tax in question. In the case where the state-owner collects all of the income taxes, the state-owner would be indifferent between the two dis-

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[1] P. Kowalski, M. Büge, M. Sztajerowska, and M. Egeland, *State-Owned Enterprises: Trade Effects and Policy Implications* (OECD Trade Policy Papers 2013)

[2] http://kluwertaxblog.com/2020/07/24/covid-19-aids-difficult-time-for-tax-haven-companies/.

[3] https://www.theguardian.com/business/2018/apr/22/abellio-ns-amsterdam-express-goes-via-dublin-ireland-low-tax.

[4] https://yaleglobal.yale.edu/content/death-knell-cross-border-leasing-deals.

[5] E. Eberhartinger, and D.M.P. Samuel, *Monitoring and Tax Planning — Evidence from State-Owned Enterprises*, https://ssrn.com/abstract=3632938.

tribution channels. However, this assumption does not always hold because state-owners (e.g., federal states) may not have the right to levy their own income taxes. Therefore, in the case where a state-owner is not the tax collector, the state-owner may prefer higher dividend distributions and thus lower tax payments. As such, the degree to which a state-owner actually collects a tax (i.e., benefits from that tax) may be a determinant of tax planning activities in SOEs.

To answer this question, the authors of the study chose a sample of German companies, as Germany offers a setting where different types of governmental entities with different taxing rights (e.g., the municipalities and the federal states) act as state-owners. Moreover, the German sample includes a variety of SOEs that are comparable to privately owned companies (e.g., industries with specific regulation such as the utility sector or financial sectors are excluded). Using financial statement data, the study finds that certain state-owned entities engage in tax planning behavior that is similar to that of comparable privately owned firms. Importantly, not all SOEs exhibit the same degree of tax planning, as only those whose state-owners do not collect the income tax revenues engage in tax planning. In contrast, where the state-owner is the direct beneficiary of the SOE's tax payments — for instance, in municipalities that benefit from the local business tax on income — the SOE's tax planning is significantly lower.

Taken together, the study shows that tax planning in state-owned firms depends on the state-owner's incentives (i.e., the state-owner does or does not collect the tax and benefits from it) and thus offers new insights on the puzzling anecdotal evidence that even state-owned firms engage in tax planning. More generally, the study suggests that the governance of the firm is a determinant of corporate tax planning — even in SOEs.

HOW TO RE-INCENTIVIZE STATE-OWNERS?

But what can policymakers do, given these findings? The central question is how to incentivize state-owners toward a ''better monitoring'' of the tax functions in their firms. That is, how can governments incentivize state-owners such that their firms engage less in tax planning, which ultimately hurts a country's overall tax revenue? Following the study's findings, the most obvious answer would be a decentralization of taxing rights or a reallocation of tax revenues among federal, regional, and local states to align incentives by ensuring that all state-owners benefit from the tax revenue. However, a decentralized tax system like in Germany may not be feasible to implement in other countries due to political or constitutional reasons. And while reallocation mechanisms are often in place, they are not directly tied to the specific tax payments of an SOE and are thus unlikely to incentivize a specific state-owner in a given SOE.

Therefore, a political consensus among state-owners to commit to ''good tax governance'' in their SOEs seems much more promising. The basis of such a commitment can be a political consensus with or without public announcement — a public commitment would arguably be a stronger tool though — or even a legally binding agreement. Such assurance of good tax governance for SOEs would add to the OECD's and the European Commissions frameworks of good tax governance, which primarily address private entities. In addition, SOEs could set an example for privately owned firms and create positive spillover effects. Such ''peer pressure'' has already worked well in other areas such as gender diversity; self-binding legislation in 2011 has significantly increased the share of women in supervisory boards of Austrian SOEs to 43% in 2019.[6] This created pressure on public corporations, which since 2018 have needed to ensure that their supervisory boards include 30% of the underrepresented gender. SOEs, which a have grown in number due to the Covid-related government aid, could set such a benchmark for tax morale as well.

The commitment to good tax governance for state-owned firms needs translation into specific measures to monitor managements tax behavior. Independent supervisory board members with financial expertise can strengthen the firms governance structures. The state can adequately incentivize management by linking variable compensation to profit before tax (instead of profit after tax). Management contracts can explicitly address ethical standards in general and the objective of good tax governance specifically. Further, SOEs could commit explicitly and publicly to good citizenship and good tax governance.

THE POTENTIAL FRUITS OF 'GOOD TAX GOVERNANCE'

Taken together, empirical evidence supports the hypothesis that even state-owned firms avoid taxes if the state-owner does not benefit from the tax revenue. To reduce tax avoidance in state-owned firms, a political agreement for good tax governance seems adequate. Such policy could lead to better monitoring of management and to state-owned firms setting a benchmark for privately owned firms.

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[6] https://www.bundeskanzleramt.gv.at/agenda/frauen-und-gleichstellung/gleichstellung-am-arbeitsmarkt/frauen-in-fuehrungs-und-entscheidungspositionen/frauen-in-wirtschaftlichen-fuehrungspositionen.html.

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