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**Taxation of State Owned Enterprises:
A Review of Empirical Evidence from China**

Wei Cui

Forthcoming in Benjamin Liebman and Curtis Milhaupt (Eds.), *Chinese State Capitalism and Institutional Change: Domestic and Global Implications* (Oxford University Press, 2015)

Abstract:

This chapter reviews empirical evidence from China that bears on the general theory of the income taxation of state-owned enterprises (SOEs). Prior theoretical literature has offered three conflicting views of SOE taxation. The first is that SOE taxation is superfluous, because the government shareholder can simply demand profit distributions. The second is that SOE taxation is necessary to put state-owned and private firms on an equal competitive footing. The third view holds that the significance of SOE taxation lies in the fact that SOE managers, like managers of private firms, may be dividend averse; in the absence of other effective mechanisms to secure adequate payout, SOE taxation serves the purpose of forcing distributions.

These conflicting theoretical views should be empirically testable. In particular, the first view suggests that SOEs should be insensitive to the income tax, that they would not pursue domestic tax planning, and that a firm's tax sensitivity should rise as it becomes more privatized. By contrast, the third view suggests that SOEs are likely to be tax sensitive, and that such tax sensitivity is as much a function of managerial compensation and the degree of shareholder monitoring as it is of the proportion of government ownership. The chapter shows that recent advanced accounting research on Chinese listed companies augments already strong historical and legal evidence that supports the third view. Chinese SOEs, particularly centrally-owned SOEs, engage in extensive tax lobbying, and display degrees of tax planning similar to private firms. The chapter suggests that further empirical research on SOE taxation should be designed with a more explicit aim of testing the above theories, for example by examining whether countries that encounter greater problems with SOE corporate governance also rely more heavily on SOE income taxation.

Introduction

The topic of taxation lies at the core of any fundamental theory of state-owned enterprises (SOEs). This is because any such theory must address the question of why there are SOEs to begin with. The likelihood of market failures resulting from purely private activities does not offer an adequate explanation for the scope of SOE activities observed around the world: in many countries, SOEs operate in sectors that may well be (and that in other countries are) efficiently served by private firms alone. The expanded scope of SOE activity must be

understood in terms of governments' desire to control the resources and production decisions in the economy other than for efficiency reasons.¹ Yet taxation is an obvious alternative for governments to control resources and production decisions. Any organization of production in the form of SOEs thus reflects an implicit choice not to rely (solely) on tax instruments. Along these lines, some economists have postulated that problems in tax policy implementation—such as the distortionary costs of high taxes and the challenges of tax administration (especially in developing countries) — partially explain the choice of public ownership of production.² Many non-economists may also share this intuition.

Interestingly, this conceptual connection between the topics of taxation and SOEs may have led economists to neglect the taxation *of* SOEs. The income taxation of SOEs is a very widespread phenomenon, and has been so for many decades.³ Yet it has received relatively little attention in social scientific and legal scholarship. There are numerous possible explanations for this neglect, one of which is the strength of theoretical intuition that, if state ownership is an alternative to taxation, then the taxation of income from state-owned assets cannot be necessary, and therefore can be of only secondary importance.

But an additional, sociological explanation may be that many of the intellectual advances in public economics, corporate finance, and related areas—advances that heavily influence the

¹ Ian Bremmer, for instance, defines “state capitalism” as a system of state dominance that allows “governments to minimize the political risks they face by maximizing their control over activities that generate substantial amounts of wealth.” IAN BREMMER, *THE END OF THE FREE MARKET: WHO WINS THE WAR BETWEEN STATES AND CORPORATIONS?* 157 (2010).

² See, e.g., JAMES E. MEADE, *LIBERTY, EQUALITY, AND EFFICIENCY* (1993); Roger Gordon, *Taxes and Privatization*, in *PUBLIC FINANCE AND PUBLIC POLICY IN THE NEW CENTURY* 185 (Sjibren Cnossen & Hans-Werner Sinn eds., 2003); Harry Huizinga & Soren Bo Nielsen, *Privatization, Public Investment, and Capital Income Taxation*, 82 *J. PUB. ECON.* 3, 399 (2001).

³ For earlier surveys, see Robert H. Floyd, *Some Aspects of Income Taxation of Public Enterprises*, 25 *IMF STAFF PAPERS* 2, 310 (1978); Glenn P. Jenkins, *Taxation of State-Owned Enterprises: Discussion Paper No. 225* (available at http://www.queensjdiexec.org/publications/qed_dp_69.pdf) (1986). For more recent information on this topic, see Wei Cui, *Taxing State-Owned Enterprises: Understanding a Basic Institution of State Capitalism*, forthcoming in *OSGOODE HALL LAW JOURNAL*.

research orientation of scholars today, legal scholars included—post-date the wave of privatization that swept through advanced economies in the 1970s and 1980s. Consequently, scholars in these economies have had less and less empirical material (not to mention diminished professional incentives) in their own countries to study SOEs. Theoretical views about most aspects of state ownership, including the taxation of SOEs, remain stagnant because they tend not to be empirically updated.

In this chapter, I offer a preliminary survey of recent empirical evidence regarding SOE taxation. In particular, I am concerned with the issue of how sensitive SOEs are to income taxation: whether they behave similarly to, or differently from, private firms in response to income taxation. This survey has both a theoretical and an empirical motive. From a theoretical perspective, as I explain in Part I, certain longstanding and competing perspectives on the justification for subjecting SOEs to income tax need to be adjudicated empirically. In particular, three different views of the income taxation of SOEs—that SOE taxation is superfluous, that it is necessary to ensure fair competition among state-owned and private firms, and that it is a form of forced distribution to deal with principal-agent problems in setting SOE dividend policy—are all in serious need of empirical verification. At the same time, without adopting the aim of testing theories of SOE taxation, recent empirical research conducted in different countries—and especially in China—has also uncovered interesting patterns in SOE taxation. However, the scholars who carried out this research make conflicting and largely unanalyzed assumptions about the nature of SOE taxation. It is important to hold these unreflective assumptions up against the light of a theory, so that the results can be interpreted in a more consistent manner and be made more robust in future research.

Although much of the evidence surveyed here comes from China, and its interpretation sometimes draws on an understanding of specific features of Chinese state capitalism, this evidence helps to evaluate theories that may apply to SOEs anywhere. The most remarkable feature of this evidence is that it seems to turn the theoretical intuition described at the beginning of this chapter on its head: instead of state ownership supplanting taxation as a form of state extraction and control, taxation remains fundamental to the state-owned sector.

This chapter proceeds as follows. Part I will summarize three competing views of the justification for SOE income taxation and explains how their empirical implications differ and may be tested.⁴ Part II briefly outlines the history of SOE taxation in China. Part III presents original qualitative evidence of Chinese SOE tax lobbying from recent years, supporting the conclusion that SOEs are tax-sensitive. Part IV then selectively reviews some recent studies in corporate finance and accounting (in both English and Chinese) that analyze SOE tax sensitivity, either in terms of the determinants of firm effective tax rates (ETRs) or in terms of firms' pursuit of specific tax-reduction strategies, such as borrowing and shifting income to low-tax affiliates. The Conclusion discusses the prospects for further empirical findings and their implications.

I. Competing Theoretical Perspectives on SOE Income Taxation

Why would a government subject its own SOEs to income taxation? The corporate income tax is collected from corporate profits, but if an SOE is wholly government-owned, its profit in theory already belongs to the state, and the state could access such profit by requiring dividend distributions. A tax on corporate profits merely reduces the amount of profits otherwise distributable. To many commentators, this suggests that SOE taxation merely transfers money

⁴ This section is based on Cui, *supra* note 3.

from one pocket of the government to another. Why then do so many governments insist on this seemingly ritualistic exercise?

Past public and academic discourses have presented three conflicting perspectives on these questions. The first perspective holds that SOE taxation is indeed superfluous, and is meaningful only in special circumstances. Generally, there is no need to tax income from publicly owned assets because that income already belongs to the government. Therefore, the taxation of SOEs is an arrangement that one should “see through” as being fundamentally different from taxing private firms. The special circumstances that justify taxation of SOEs include partially privatized firms (non-taxation of such firms would provide unwarranted favorable treatment of private investors in the firms), as well as revenue-sharing arrangements where government entities other than the SOEs’ owners are recipients of tax revenue. But beyond these circumstances, according to this first perspective, SOE income taxation possesses neither general justification nor institutional significance.

The second perspective on SOE taxation could not be more different. It holds that SOE taxation is necessary to put SOEs on an equal footing with private firms: unless SOEs are taxed in the same way as private firms, one type of firm may suffer a competitive disadvantage relative to the other. Therefore SOE taxation is dictated by norms of market neutrality. This second view appears to have wide influence in both advanced and developing economies, and to be reflected in the policies and laws of many countries (including some constitutions and treaties). This is rather remarkable, since the view flatly contradicts the first perspective on SOE taxation, which also seems to possess considerable plausibility when first presented. The co-existence, for a long time, of these two mutually incompatible views bears witness to the weakness of existing understandings of SOE taxation.

Yet a third perspective on SOE taxation can be found in the writing of a small number of public economists who had studied publicly owned enterprises before such studies became decidedly unfashionable.⁵ This view sees SOE income taxation as playing the role of forcing distributions from SOEs: collecting the income tax from SOEs secures profit distributions to the government shareholder in a way that enjoys practical advantages over dividends. The difference between this view and the first view (that taxing SOEs simply moves funds that the government is entitled to from one account (“pocket”) to another) is that, even if the income tax and dividends paid by an SOE are functionally similar from the perspective of the government, taxes and retained earnings are not. A key inference in the first view is from the equivalence of tax and dividends to the equivalence of tax and retained earnings. The latter equivalence is needed for the conclusion that SOE taxation has no behavioral consequences (and therefore is ultimately superfluous). Yet if securing dividend payouts from SOE earnings is a significant institutional issue, that equivalence does not hold, and SOE taxation can have significant consequences just like the taxation of private firms.

The first two perspectives—mutually contradictory as they are—are probably much better known than the third, and one can offer some plausible speculations as to why. By the 1980s, principal-agent problems in state-owned firms in mixed economies were already recognized, just as such problems in private firms had been.⁶ But the subsequent trend of privatization has meant that scholarly attempts to articulate corporate governance problems in SOEs are far outnumbered by similar studies in the private firm context. Therefore, while principal-agent problems in SOEs for formulating dividend policy (and their manifestation in the

⁵ See Floyd, *supra* note 3; Jenkins, *supra* note 3; John Whalley & Li Wang, *The Unified Enterprise Tax and SOEs in China*, in CHINA’S INTEGRATION INTO THE WORLD ECONOMY 179 (John Whalley ed., 2013).

⁶ See, e.g., JOHN ROEMER, A FUTURE FOR SOCIALISM (1994); Joseph Stiglitz, *The Economic Role of the State: Efficiency and Effectiveness*, in EFFICIENCY AND EFFECTIVENESS IN THE PUBLIC DOMAIN 37 (T.P. Hardiman & Michael Mulreany eds., 1991).

continued practice of SOE taxation) may have remained a significant concern in practice in many countries,⁷ they became less studied. At the same time, the spirit of privatization also gave appeal to the second perspective: insofar as the economy is not entirely privatized, measures must be taken to ensure that SOEs do not derive unjustified advantage over private firms.

However, recent scholarship on corporate governance in private firms actually gives strong support to the intuition that securing adequate dividend payouts from SOEs could be a serious challenge. In particular, it has been shown in the private firm context that shareholder monitoring and equity-based incentives for managers significantly increase firms' likelihood of making distributions. Yet these are precisely the mechanisms that SOE shareholders cannot rely on. The weakness of shareholder monitoring in SOEs has been extensively documented and was indeed an important impetus for privatization.⁸ Moreover, unless an SOE is privatized, equity-based compensation for managers is also by definition impossible. Setting performance targets for dividend distributions for SOE managers could also simply aggravate the already complex incentive problems for multitasking managers.⁹ Finally, SOEs (especially wholly-owned ones) cannot easily go to the private capital market to seek equity financing, while obtaining public funding through the budgetary process is likely to be politically challenging. Therefore, simply for operational reasons, their managers can be expected to have greater incentives to hoard cash than private firm managers. In other words, research from the last two decades on private firms suggests that we have reasons to expect SOE managers to be more dividend-averse than private firm managers.

⁷ See, e.g., LOUIS KUIJS ET AL., *SOE DIVIDENDS: HOW MUCH AND TO WHOM?* (2005).

⁸ See Aldo Musacchio & Sergio G. Lazzarini, *Chapter Name*, in *this volume*

⁹ See, e.g., Chong-En Bai & Lixin Colin Xu, *Incentives for CEOs with Multitasks: Evidence from Chinese State-Owned Enterprises*, 33 J. COMP. ECON. 3, 517 (2005).

But this renders the first perspective on SOE taxation non-viable: if the chasm between dividends and retained earnings is great for SOEs, and if dividend and tax are equivalent for SOEs, their managers should be expected to be very averse, rather than indifferent, to paying tax. Note also that insofar as privatization alleviates monitoring and incentive problems for dividend distributions, managers of partially-privatized SOEs should become less dividend-averse. In the forced-distribution view of SOE taxation, this weakens the justification for taxing the public portion of SOE profits, whereas from the first perspective on SOE taxation partial privatization is actually what creates the need for SOE taxation in the first place.

The first and third perspectives on SOE taxation have other sharply different empirical implications as well, which means that one should be able to evaluate their respective validity with real-world evidence. For example, the first perspective implies that managers of wholly-owned SOEs should be indifferent to the income tax, or at least much less tax-sensitive than private firm managers. As the state owner share in a partially privatized company increases, the company should also become less sensitive. Firms paying tax to just their own shareholder government should also be less tax-sensitive than firms whose revenue goes to other government entities under revenue sharing arrangements. By contrast, the “forced distribution” view of SOE taxation implies that SOE tax sensitivity should be a function of the effectiveness of shareholder monitoring, SOE managers’ opportunities to use funds for investment and operations as well as private gain, and incentive arrangements made with shareholders. For example, an SOE’s government shareholder is in a position to reward its managers for paying taxes, which it would not normally do for private firms. This means that the degree of SOE tax sensitivity—whether it is less than, equal to, or greater than private firm tax sensitivity—is *intrinsically* an empirical matter.

What about the second perspective? While it advances a normative claim (that not taxing SOEs, or taxing them differently from private firms, would create “unfair” competition), it is based on factual assumptions that can also be empirically tested. Although these assumptions are rarely stated by those who advocate the second perspective, they must be that non-taxation (or different taxation) of SOE corporate profits would distort competition in the capital market, in factor markets other than the market for capital, and/or in product markets. However, it is difficult to see how such assumptions can hold, given two facts. First, the private capital market and the public budget are two entirely different sources of equity funding: private firms do not generally have access to the former, and wholly-owned SOEs do not have access to the latter. Therefore private firms and SOEs do not compete for equity financing.¹⁰ Second, it is likely that the governmental supply of equity capital to SOEs is largely inelastic with respect to the return on the capital. Therefore, any tax on such return is likely to be borne entirely by the government owner of the return, instead of being passed on to consumers or suppliers of other productive factors. Any story about distortions created by differential taxation (including exemption) of SOE profits must therefore involve unusual circumstances that differ from these two more common factual patterns.¹¹

It is not difficult to see that which of the three competing theories is correct (and under what circumstances) should be of significant interest to policymakers who have to deal with

¹⁰ For debt financing, because SOEs tend to have better access to loans than private firms (due either to implicit government guarantees or to policy-directed lending), they would enjoy a greater benefit from interest expense deductions if they were subject to tax, whereas there would be no tax-induced advantage from borrowing if SOEs were exempt from the income tax.

¹¹ In fact, given that the public discount rate is likely to be different from the private discount rate for making investment decisions, the cost of capital likely already differs between SOEs and private firms before the income tax is taken into account. There is no level playing field to start with, and it is not clear that it matters.

SOEs.¹² For example, if the first theory is wrong and SOEs are tax-sensitive, then behavioral distortions from SOE taxation must be taken into account, and tax policy design for SOEs could be just as complex as for private firms. If, on the other hand, the second theory is also wrong, then the normative guideline of equal taxation of SOEs and private firms may also need to be abandoned. The resolution of the conflicts among the competing theories is thus important. In the rest of this chapter, I will focus on recent empirical evidence that helps evaluate the strengths of the first and third theories (i.e. the superfluity and the forced-distribution views). Before offering contemporary evidence, however, I briefly review the historical path of SOE taxation in China.

II. A Brief History of Chinese SOE Income Taxation

China began considering taxing SOEs in the early 1980s. Prior to that time, SOEs operated in a command economy, where production decisions were administratively determined.¹³ The transition out of the planned economy began with loosening control over production decisions and giving managers incentives to improve productivity. An important obstacle was that, previously, almost all profits of any enterprise had to be immediately surrendered to the government (while loss-generating firms simply received additional funds). The need for SOE managers to retain some profits became apparent. How much retention would be allowed became a central question. In 1983 and 1984, the government carried out two rounds of reform addressing this issue. Instead of requiring the surrender of all profit, SOEs were

¹² As Ian Bremmer and many others have pointed out, these include even policymakers from countries with relatively low SOE presence. *See* BREMMER, *supra* note 1.

¹³ Turnover taxes were imposed on SOEs and generated significant revenue. *See* Christine P. W. Wong, *Fiscal Reform and Local Industrialization: The Problematic Sequencing of Reform in Post-Mao China*, 18 *MOD. CHINA* 197, 200–04 (1992). For a theoretical discussion of the role of turnover taxes in planned economies, see RICHARD A. MUSGRAVE, *FISCAL SYSTEMS* 40–62 (1969).

generally subject to a 55 percent income tax. After-tax profits were further divided between SOEs and their government owners according to a variety of formulae, but the 55 percent tax set a baseline. By the end of 1983, 92.7 percent of profitable SOEs “switched from surrendering profits to paying taxes.” The average profits retained by SOEs as a percentage of total before-tax profits increased—though not by a lot—from 15.7 percent to 17.9 percent.¹⁴

The tax on SOEs, therefore, was instituted explicitly as a substitute for distributions. It allowed firms to retain *some* profits, while avoiding extensive bargaining between firms and government owners. Although this resonates with the “forced distribution” theory of SOE taxation, one needs to remember that “forced distribution” is a theoretical construct to explain SOE taxation generally, and not a description of how particular countries conceived of SOE taxation at particular times. It is easy to point out, for example, that the Chinese economy in 1983 was only beginning to be reformed, product markets were just being introduced, and urban labor, credit and capital markets barely existed. In that setting, taxing SOEs obviously was not a solution to the relatively narrow problem of corporate governance with respect to payout policy, but an attempt to deal with more basic problems of organizing production without markets. Moreover, SOEs dominated the Chinese economy at that time. Both because of this, and because few other tax instruments were deployed, the government relied heavily on income from SOEs for revenue.¹⁵ This explained the very high tax rates imposed on SOEs and how little SOE managers were allowed to retain even after “switching to paying taxes.”¹⁶

¹⁴ Zuo Liu 刘佐, 国营企业“利改税”及其历史意义 (SOEs’ switch from surrendering profits to paying taxes and its historical significance), 10 税务研究 (TAX’N RES.) 30 (2004).

¹⁵ See 14 for a summary of the sequence by which other taxes were introduced while the taxation of SOEs was implemented. See also Zuo Liu 刘佐, 中国企业所得税体制的发展 (The development of China’s enterprise income tax system), 1 辽宁税务高等专科学校学报 (LIAONING TAX’N C. J.) 1 (2007). According to Kuijs, et al in 1978,

However, the forced-distribution theory can help to explain a fact about the “switching to paying taxes” system that has been somewhat obscure in China—namely that the system quickly collapsed.¹⁷ By 1987, many SOEs switched to another regime of “contracting responsibility,” where the government effectively contracted out the management of SOEs for a pre-fixed amount of tax and profits, and where the firms retained all profits in excess of that amount.¹⁸ Why the “switching to paying taxes” system was abandoned within three years of implementation is not much discussed in China. One possibility is that because many SOEs were locally owned, other claimants to SOE funds/profits (e.g., local governments) did not like the forced distribution mechanism represented by the tax on SOEs, and helped SOEs to hide income from the tax authorities.¹⁹ Others postulate²⁰ “widespread [tax] evasion” as partially causing the demise of the system: because financial accounting was just beginning to be practiced in the 1980s, it was very difficult for the government to determine firms’ taxable income. As a result, tax payment was low despite the high tax rate. Both of these explanations imply that SOEs can be sensitive at least to high taxes and would even engage in tax evasion—supporting the forced-distribution view.

In any case, because of quick economic growth and inflation, the government rapidly turned out to be the loser in the “contracting responsibility” bargain, and the country’s public fisc

revenue from enterprises was the largest source of budget revenue and accounted for more than half the total. KUIS, *supra* note 7, at 2.

¹⁶ This system of reliance on SOE distributions thus violates a plausible assumption, namely that SOE distributions are desirable only when the return to reinvestment is lower than the public rate of discount. *See* Cui, *supra* note 3, at 13-14.

¹⁷ Wong, *supra* note 13.

¹⁸ 13; Youxiang Zuo 褚友祥, 改革开放以来我国国有企业所得税发展述评 (Income taxation of state-owned enterprises since reform and opening), 3 辽宁税务高等专科学校学报 (LIAONING TAX’N C. J.) 1 (1999).

¹⁹ *See* Christine Wong, *Central-Local Relations in an Era of Fiscal Decline: The Paradox of Fiscal Decentralization in Post-Mao China*, 128 CHINA Q., 691 (1991); Hongbin Cai & Daniel Treisman, *State Corroding Federalism*, 88 J. PUB. ECON. 819 (2004).

²⁰ Roger Gordon & Wei Li, *Taxation and Economic Growth in China*, in CRITICAL ISSUES IN CHINA’S GROWTH AND DEVELOPMENT 22 (Y. K. Kwan & E. S. H. Yu eds., 2005).

was in danger by 1993. The crisis instigated the major tax reform in 1994, when all domestically-owned enterprises, whether government or privately held, became subject to the same enterprise income tax. By this point, the government no longer depended as heavily on income from SOEs for revenue: the VAT and other turnover taxes were making the largest contributions to the budget. In addition, the state-owned sector was also beginning to shrink, as market liberalization proved many SOEs to be non-viable. Consequently, SOE taxation became less important from a revenue perspective. Justifications for it in terms of the need to put SOEs and private firms on an equal footing began to be circulated, notwithstanding the questionable underlying assumptions about the incidence of the income tax on SOEs.

What has become a focus of debate since then is how to design China's SOE dividend policy, as many surviving SOEs have become very profitable. SOEs' retention of profits has stood at what seems to be an obviously inefficient level. As a study by the World Bank in 2005 put it: "If 50 percent of SOE profits, estimated at 6.5 percent of GDP in 2004, were distributed to the budget and spent on education and health, this would allow an 85 percent increase in government spending on education and health."²¹ The dividend averseness of Chinese SOEs can be illustrated by some more recent figures. In 2010, Chinese SOEs at the national and sub-national levels altogether earned 1.987 trillion yuan of profits, equivalent to 5 percent of GDP. If all such profits were distributed, the amount would be equivalent to 27.14 percent of total tax revenue in 2010.²² However, SOEs owned by the central government, which accounted for 57

²¹ KUIJS, *supra* note 7, at 7.

²² The 2008 figures are computed from Ministry of Finance, People's Republic of China, *Report on the Implementation of the 2008 Central and Local Budgetary Plans and the Draft Central and Local Budgetary Plans for 2009*, THE NATIONAL PEOPLE'S CONGRESS OF THE PEOPLE'S REPUBLIC OF CHINA (March 5, 2009), http://www.npc.gov.cn/englishnpc/Special_11_2/2009-03/15/content_1493326.htm; the 2010 figures from Ministry of Finance, People's Republic of China, *Report on the Implementation of the 2010 Central and Local Budgetary Plans and the Draft Central and Local Budgetary Plans for 2011*, THE NATIONAL PEOPLE'S CONGRESS OF THE

percent of total SOE profits, distributed only 3.8 percent of their profits to their government shareholder.²³ In fact, this was already a large improvement over the 0.86 percent rate of profit distribution in 2008. All such dividend proceeds in 2010 were used (as in prior years) to reinvest in SOEs: that is, state-owned assets made no revenue contribution to the general state budget.²⁴ Concrete proposals for developing institutions to achieve adequate payout from SOEs are slow to materialize. For 2011, the highest dividend payout rate, applicable to fifteen centrally-owned SOEs, was set at 15 percent of after-tax profits,²⁵ yet the distributions have not been included in the general budgets, but simply recycled into SOE investments.

By contrast, the enterprise income tax (EIT) generated 1.284 trillion yuan of tax revenue in 2010. All of China's SOEs are subject to the enterprise income tax, and in recent years SOEs contributed well over 10 percent of total EIT collected. All tax revenue is included in the general government budget. Thus both in recent history and for the foreseeable future, SOE income tax payments dominate SOE profit distributions.

Interestingly, SOEs often try to deflect criticism about their hoarding of funds and dividend-averseness by touting the amount of tax they pay. In officially-organized annual

PEOPLE'S REPUBLIC OF CHINA (March 5, 2011), http://www.npc.gov.cn/englishnpc/Special_11_4/2011-03/18/content_1647917.htm.

²³ *Report on the Implementation of the 2010 Central and Local Budgetary Plans and the Draft Central and Local Budgetary Plans for 2011*, *supra* note 22. For most SOEs, the ultimate shareholder is the State Asset Supervision and Administration Commission (SASAC). State-owned financial institutions are held through the China Investment Corporation (CIC) and its subsidiary Huijin. Interest and dividend payments by CIC to the government also fall outside the general budget.

²⁴ 22

²⁵ 关于完善中央国有资本经营预算有关事项的通知 (Notice regarding issues in improving the operating budget for central state-owned assets) (promulgated by the Ministry of Finance, Dec. 23, 2010), http://qys.mof.gov.cn/zhengwuxinxi/zhengcefabu/201012/t20101229_393241.html. A 10 percent payout rate will apply to a second category of seventy-eight centrally-owned SOEs, and a 5 percent payout rate to a third category of thirty-three centrally-owned SOEs. No data is available for the practice of sub-national governments with respect to their SOEs.

rankings of firms by their tax payments²⁶ SOEs routinely show up as by far the largest taxpayers. The state-owned China National Petroleum Corporation, for example, boasts of having “paid” by itself 3.6 percent of the national tax revenue in 2007. The chairman of SASAC once told the press that, in 2008, SOEs under his supervision were expected to have “paid” over 1 trillion yuan in taxes²⁷—close to 20 percent of the year’s national tax revenue. Such announcements are patently disingenuous, as the amounts reported consist mostly of remittance of indirect taxes (such as the value added tax and the excise tax), the economic burden of which is passed on to consumers and which the SOEs do not bear. Even putting this aside, Chinese SOEs’ reluctance to pay profit distributions raises the question of how willing they really are to pay taxes. As the next section will show, the image of Chinese SOEs as unhesitating taxpayers masks the fact that they also seek some of the most favorable tax treatments.

III. The Central SOE Tax Lobby

A fact little known outside the elite world of powerful SOEs and senior policymakers in China is that SOEs constitute by far the most powerful and effective tax lobby. The special benefits SOEs seek can take the form either of special rulings for particular SOEs, or of rules that have the appearance of being generally applicable but that, given other economic and regulatory circumstances, predominantly benefit SOEs. These special benefits can be interpreted in a variety of ways. Some of them, such as the exemption of accrued gains that would otherwise by

²⁶ The central government has ceased to publish such rankings since 2009, but some provincial governments continue to do so. See, for example, a 2014 release of such rankings in Liaoning: Liaoning Provincial People’s Government Network 辽宁省人民政府网, 2013 年度辽宁省纳税百强企业排行榜新闻发布会 (Press conference on the ranking of top 100 taxpaying enterprises in Liaoning province in 2013) (Mar. 28, 2014), <http://www.scio.gov.cn/xwfbh/gssxwfbh/fbh/Document/1367528/1367528.htm>.

²⁷ Wang Jin 王进, 李荣融透露央企今年缴税有望破万亿 (Li Rongrong says central SOEs expected to pay taxes of over a trillion) 中国证券报 (China Security News) (December 8, 2008), http://www.cs.com.cn/xwzx/03/200812/t20081208_1676309.htm.

taxable during corporate reorganizations, can potentially be viewed as targeted, one-time, and quantifiable subsidies. Others, such as the grant of tax consolidation treatment to corporate groups, are still explicit and targeted, but are ongoing, less quantifiable, and vulnerable to manipulation. Still others, such as the international tax rules also discussed in this section, are essentially loopholes that SOEs can exploit to their indefinite advantage and are very difficult to interpret as intentional subsidies. All of them can be seen as ways in which SOEs' tax sensitivity is manifest. This is one reason why I discuss them here. Another reason is that they also potentially explain some of the empirical patterns discovered by recent finance and accounting research—for example, that listed, centrally-owned SOEs in China display ETRs that are lower than or similar to listed, privately owned firms, whereas locally-owned SOEs have substantially higher ETRs. Thus, while observations of SOE tax lobbying efforts cannot reveal the exact degree of SOE tax sensitivity—for that, quantitative studies of the kind surveyed in Part IV are needed—they comprise an important type of mechanism by which some SOEs may achieve their low ETRs. They are thus crucial to the interpretation of quantitative evidence.

A. Corporate Consolidation

Chinese corporate groups are generally not allowed to compute tax liability on a consolidated basis or to offset loss against profits across companies within a group.²⁸ Nonetheless, between 1994 and 2009,²⁹ the central government granted permission to more than 120 large SOE groups to consolidate their tax computation on the grounds of their “importance” to the nation. In China the benefit of consolidation treatment is conceived primarily or even exclusively in terms of the possibility of offsetting loss against profit across companies, and not

²⁸ This is largely because under China's central-local tax sharing system, sub-national governments can claim only a share of the EIT revenue that is paid within their jurisdictions. Local governments are thus loath to cede revenue to the jurisdiction of the parent company of a group.

²⁹ The central government decided to suspend consolidated tax reporting for these enterprises beginning in 2009, in order to offset the revenue loss to local government generated by China's VAT reform.

(as in advanced economies that adopt corporate tax consolidation) in terms of administrative simplification or tax neutrality with respect to business organizational choices. That is, it is generally interpreted by both the government and taxpayers to be a form of tax preference.³⁰ The central government has zealously guarded the authority to approve this type of tax preference and has prohibited local governments from authorizing similar treatment. Although some local governments have granted consolidated tax treatment in the past to SOE groups that have local importance, the prohibition by the central government make this less common (and less well documented). SOE corporate groups also cannot self-determine their eligibility for group consolidation: each group lobbies for special treatment, and which ones receive it is a matter of political clout.³¹ Fewer than 10 percent of SOE groups in China were permitted to adopt EIT consolidation prior to such practice being suspended in 2009.³² The government estimated the magnitude of the tax savings to the selected groups from consolidation to be 40 billion RMB per year, equivalent to 4.1 percent of the total amount of EIT revenue collected in 2007 and over 25 percent of all EIT paid by SOEs.³³

This preferential policy for SOEs has been questioned in recent years,³⁴ not only on the basis that it constitutes discriminatory treatment vis-à-vis privately-owned corporate groups,³⁵ but also because the policy subsidizes favored SOE groups that keep loss-generating subsidiaries.

³⁰ See Shouwen Zhang 张守文, 企业集团汇总纳税的法律解析 (Legal analysis of the aggregated taxation of enterprise groups), 5 法学 (LEGAL SCI.) 39 (2007).

³¹ A corporate group being state-owned is thus a necessary, but not sufficient, condition for eligibility for consolidated reporting.

³² It is estimated that, as of 2010, there were close to 1500 SOE corporate groups in China, representing roughly half of the total number of corporate groups..

³³ Computation based on CHINA'S TAX PRESS, TAX YEARBOOK OF CHINA (2008).

³⁴ See Lei Liu 刘磊, 论现代企业组织形式与所得课税 (On the forms and income taxation of modern enterprise organizations), 11 扬州大学税务学院学报 (J. TAX C. YANG ZHOU U.) 19 (2006); Wenchuan Xia 夏文川, 对企业所得税汇总(合并)纳税的思考 (Study on the aggregated (consolidated) income taxation of enterprises), 1 税务研究 (TAX'N RES.) 44 (2007).

³⁵ This claim of discrimination reflects the second perspective on SOE taxation discussed in Part I, *supra*. This is one example where deciding whether that perspective is correct has real world policy implications.

Since Chinese SOEs often operate in sectors that are occupied by private firms in other countries, losses typically reflect inefficiencies. The tax subsidy of consolidation treatment thus potentially slows the divestiture of inefficient SOEs. However, regardless of the merits of the criticisms and defenses of the policy, all seem to agree that having such preference or not *matters* to SOEs: that is, all SOEs, even the most profitable ones, care about whether the losses of some subsidiaries are taken into account in computing tax liability. This would be inexplicable if one adopts the position that SOEs cannot be tax-sensitive.

B. Special Treatment of Corporate Reorganizations

Since the late 1990s, partly to facilitate the restructuring of the state-owned sector, China's Ministry of Finance (MOF) and State Administration of Taxation (SAT) experimented with a variety of tax-deferred corporate reorganizations.³⁶ Like their counterparts in the U.S. and elsewhere, these rules impose conditions on the transactional forms and types of consideration used in reorganizations, which, if satisfied, allow the reorganized companies and their shareholders to defer recognition of gain on the transfer of assets and stock. Both SOEs and private firms are permitted to use these rules. In a typical SOE reorganization, the parent company of an SOE group would re-arrange its myriad subsidiaries, often with the aim of packing "good assets" into a joint-stock holding company to be listed on a domestic or foreign stock exchange. Because the reorganizations have largely been done intra-group, most of the transactions could have been carried out in forms that qualified them for tax deferral.

However, a significant number of SOE groups have chosen *not* to take advantage of these rules. Instead, these SOEs petitioned the MOF and SAT to treat the reorganizations as taxable, so

³⁶ See Wei Cui & Richard Krever, *The Tax Consequences of Corporate Reorganisations in China*, 3 BRITISH TAX REV. 340 (2011).

that after the transfer the tax basis of the relevant stock or assets was “stepped up” to their fair market value.³⁷ At the same time, the SOEs asked the government permanently to *exempt* from tax the gain that should have been recognized on the transactions. Close to forty rulings for such “tax-exempt” reorganization were issued between 2000 and 2011. According to figures offered in the rulings themselves, between 2000 and 2007 the special treatment resulted in the exemption of 87.2 billion yuan of tax liability. During 2008 and 2009 the continuation of this type of special treatment resulted in 19.4 billion yuan of tax benefit to the relevant companies.³⁸

In the rulings, the MOF and SAT have attempted to rationalize this type of permanent tax exemption (as opposed to tax deferral) as an investment decision: in each case, the government’s share of the paid-in capital of a reorganized stated-owned enterprise is required to be increased by the amount of the foregone tax revenue. Thus, conceptually, each relevant enterprise is treated as fictionally paying tax on the gain it recognizes on asset and stock transfers in a reorganization. But the fictional tax does not enter the state treasury, and is instead immediately re-contributed back into the company. However, this theory of the tax-exemption of SOE reorganizations is ad hoc and inconsistent with the details of its implementation: how much tax is saved usually depends on the SOE group itself, and not on the fictional government investor.³⁹ For example, even the assets and stock of lower-tier subsidiaries for which there is no direct ownership change are stepped up without taxation. In such cases, it is difficult to identify either the taxable event (because ownership has not been transferred) or the person making the investment decision

³⁷ “Stepped-up” basis creates tax benefits through increased depreciation deductions.

³⁸ See Wei Cui 崔威, 国有企业重组的“超特殊”税务处理: 法律背景及评议 (“Super-special” tax treatment of state-owned enterprise reorganizations: legal framework and evaluation), 22 中外法学 (PEKING U. LAW J.) 944 (2010).

³⁹ Because investment decisions for China’s non-financial SOEs as well as their distribution policies generally fall under the supervision of SASAC, the claim that the MOF or SAT could also decide on the making of a capital injection into these SOEs appears, from an institutional perspective, to be questionable.

(because the subsidiaries are only indirectly owned by the state).⁴⁰ A more straightforward explanation of these tax preferences is that powerful SOEs lobbied for them, and in some (but by no means all) cases, the government succumbed to the lobbying.⁴¹

Like tax preferences granted to SOEs in the consolidated return area, special SOE treatment in corporate reorganizations suggests two things: one, SOEs are sensitive to the corporate income tax—otherwise they would not lobby for favorable tax treatment unavailable to others; and two, they are able to use their political clout to bargain with the government regarding tax matters.

C. International Taxation

The next examples demonstrate how SOEs not only seek explicit and targeted tax preferences, but also generally attempt to influence tax policy making to their own advantage. They thus offer even stronger evidence for SOE tax-sensitivity.

Starting in the early 1990s, so-called “round-tripping” investment structures began to be widely observed in Chinese foreign direct investment. These structures involved Chinese parties setting up a group of offshore holding companies in tax haven countries and transferring the equity interest of Chinese entities to such holding companies. Thus Chinese individuals and companies ended up owning and controlling foreign entities, the only assets of which may be Chinese companies’ shares (hence the label “round-tripping”). The structures were popular because they allowed Chinese businesses to raise capital overseas and circumvent domestic

⁴⁰ See Cui, *supra* note 38 for a detailed discussion of these issues.

⁴¹ Indeed, the number of SOEs that engaged in pre-listing reorganizations far exceeds the number of SOEs that obtained tax exemption rulings.

regulatory requirements.⁴² Among all users of such structures, SOEs stood out in that they tended to be the only Chinese companies—as opposed to individuals—that were the ultimate owners in the investment structure. This was because for all Chinese enterprises, making investments overseas (e.g., setting up offshore subsidiaries) was subject to strict capital control requirements, and generally only SOEs obtained approval for such investments.⁴³ In other words, if the ultimate owner in a round-tripping structure was a Chinese company, it was highly likely that it was an SOE.

In 2008, the new Enterprise Income Tax Law rendered round-tripping structures highly tax-inefficient for Chinese SOEs. When a Chinese operating subsidiary distributed dividends to its offshore parent, the dividends began to be subject to Chinese withholding tax.⁴⁴ And if such amounts distributed were further repatriated to the Chinese company that was the ultimate owner, the latter had to pay corporate income tax on the full amount.⁴⁵ By contrast, if a Chinese operating subsidiary distributed after-tax profits directly to a Chinese parent, the parent would retain the entire amount because of the inter-corporate dividend exemption under the EIT.⁴⁶

From a tax planning perspective, one way out of this quandary is to rely on the basic definition of resident enterprises under the EIT Law, according to which an offshore company

⁴² Before 2008, the structure also allowed the Chinese operating subsidiaries to be treated as foreign invested enterprises (FIEs) eligible for tax preferences.

⁴³ For privately-owned businesses, Chinese individuals tend to be the owners of the offshore holding companies, because the enforcement of capital control against individuals used to be more lax. See Thomas Hall, *Controlling For Risk: An Analysis of China's System of Foreign Exchange and Exchange Rate Management*, 17 COLUM. J. ASIAN L. 433, 450 (2004).

⁴⁴ Before 2008, dividends paid by FIEs (even if ultimately owned by Chinese residents) were subject to zero withholding.

⁴⁵ Thus if an operating company distributes \$100 of after-tax profits to its offshore holding company, a 10 percent withholding tax may be levied. The remaining \$90, if subsequently repatriated to the Chinese corporate owner of the offshore holding company, would be subject to a 25 percent enterprise income tax, leaving the ultimate owner with only \$67.5.

⁴⁶ [中华人民共和国企业所得税法] (Enterprise Income Tax Law) (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2006, effective Jan. 1, 2008), art. 26, § 2.

can still be treated as tax resident in China if it is managed and controlled within China.⁴⁷ If offshore holding companies qualify as Chinese tax residents, distributions from Chinese operating companies to offshore entities and from such entities back to the ultimate Chinese corporate owners would all be treated as domestic inter-corporate distributions. No withholding tax would apply. However, lawmakers hesitated to specify details about the “management and control” test, both because of the novelty of the concept and because it applies beyond the context of round-tripping structures. For example, giving the “management and control” criterion broad application could impose Chinese resident status on many foreign-listed companies whose assets and management are predominantly located in China.⁴⁸ This would likely pose administrative challenges that the tax administration is unprepared to face, while not necessarily raising additional revenue.

Remarkably, in April 2009 the SAT issued a circular precisely aimed at facilitating the type of tax planning just described.⁴⁹ It prescribed the conditions under which offshore entities may qualify and elect to be treated as Chinese resident enterprises. The conditions are such that, with sufficient tax planning, tax resident status will largely be an elective matter—it can easily be chosen or avoided, depending on which is more beneficial for the taxpayer. This extremely favorable set of rules, however, applies only to offshore entities controlled by “Chinese enterprises or enterprise groups”—*that is, by SOEs*. Anecdotes among practitioners suggest that the circular was shepherded through the rulemaking process by China Mobile, an SOE with

⁴⁷ 46 at art. 2.

⁴⁸ Many China-based companies listed on stock exchanges such as the New York Stock Exchange or NASDAQ adopt the round-tripping structure, as do all companies that make up the “red chip” section of the Hong Kong Stock Exchange.

⁴⁹ 关于境外注册中资控股企业依据实际管理机构标准认定为居民企业有关问题的通知 (Notice Regarding the Treatment of Chinese-Controlled, Foreign-Registered Enterprises as Resident Enterprises Under the “Body of Substantive Management” Test) (promulgated by the State Administration of Taxation, Apr. 22, 2009), <http://www.chinatax.gov.cn/n810341/n810765/n812166/n812642/c1189294/content.html>.

Hong Kong subsidiaries that hold all of the group's operating companies in China. In other words, China Mobile was able to prompt regulatory action on a subject that previously had appeared too weighty and difficult for the government to tackle. It persuaded the tax authorities to craft a rule in its favor that looks general in its application but is narrow in its impact. It made an SOE tax planning idea into law.

Indeed, for specialists who closely follow Chinese tax regulations, special policy dispensations for SOEs are so routine that they require no particular effort to document. More recent manifestations of the phenomenon in the international tax policy area include the decision by the MOF and SAT substantially to relax China's foreign tax credit (FTC) rules—but only for the three SOE corporate groups that form China's oil and gas oligopoly.⁵⁰ Generally, Chinese businesses can claim indirect FTC only for three layers of foreign subsidiaries,⁵¹ and they are subject to the “per country” limitation in computing the FTC limitation.⁵² For “Chinese petroleum companies,” however, the government simply waived the “per country” limitation and allowed indirect FTC for up to five tiers of foreign subsidiaries. While there might be arguments for relaxing these limits generally, there is no reason why petroleum companies especially deserve this policy treatment.⁵³ The sole effect of the relaxation is the reduction of the Chinese tax paid by the oil and gas SOEs—and the amount of reduction is entirely up to the SOEs

⁵⁰ 关于我国石油企业在境外从事油（气）资源开采所得税收抵免有关问题的通知 (Notice Regarding Issues in Foreign Tax Credit for Chinese Petroleum Companies Engaged in Oil (Gas) Resource Exploration Overseas) (promulgated by the Ministry of Finance, State Administration of Taxation, May 26, 2011), <http://www.chinatax.gov.cn/n810341/n810765/n812156/n812479/c1186648/content.html>. The three SOE oil and gas groups are PetroChina, CNOOC, and Sinopec.

⁵¹ That is, foreign taxes paid by such subsidiaries are deemed paid by the Chinese parent and therefore may be credited against the latter's Chinese tax liability.

⁵² The purpose of the “per country” limitation is to reduce the ability of the taxpayer to use foreign tax paid in high-tax countries to reduce the home country tax liability on income earned in low-tax countries.

⁵³ Indeed, the Bank of China (a large partially state-owned bank, but not the central bank) was able to obtain the same treatment through an unpublished private ruling in 2010.

themselves, and not to the government as a shareholder. Such policies would be inexplicable if SOEs did not care about paying the income tax.

The examples of SOE tax lobbying given in this Part are by no means exhaustive. They provide compelling evidence of SOE tax sensitivity. However, the evidence is also limited in its scope. First, because the evidence is all based on policies and rulings adopted by the Chinese central government, it offers insights primarily into the behavior of centrally-owned SOEs. Second, it cannot really reflect varying degrees of tax sensitivity, nor the relative significance of various factors that may determine such sensitivity. The next section will examine further evidence, not of attempts by SOEs to shape the content of the law, but of their behavior once the law is fixed. Such ex post behavior has been studied for both centrally- and locally-owned SOEs, and potentially reveals answers to questions regarding degrees of sensitivity and causal factors.

IV. Firm-Level Quantitative Evidence of SOE Tax Sensitivity

A. Do SOEs Display Higher or Lower Effective Tax Rates?

One basic approach to measuring SOE tax sensitivity is to compare the ETRs among firms with different types of ownership: firms with lesser tax sensitivity should show higher ETRs, because they would devote less effort to tax reduction.⁵⁴ Since ETRs are potentially determined by a large range of factors, empirical comparisons of ETRs across firms usually incorporate control variables that represent many firm characteristics that potentially affect ETR independently of the nature of firm ownership. These include firm size, leverage ratio (greater use of loan financing produces greater interest expense deductions and therefore lower ETRs), ratios of fixed assets to total assets (fixed assets generate depreciation deductions and therefore

⁵⁴ Scott Dyreng et al., *Long-Run Corporate Tax Avoidance*, 83 ACCT. REV. 1, 61 (2008).

also have a tendency to lower ETRs) and of other types of assets and inventories, measures of firm performance such as return on assets (ROA), growth prospects as measured by market to book ratios or Tobin's Q, the sectors in which the firms operate, and nominal tax rates (if they differ for different firms).⁵⁵ Thus, for example, it may be that SOEs generally have better access to loan financing and therefore claim more interest expense deductions than other firms, independent of their willingness to pursue tax planning strategies. Any effect of firm ownership on ETRs that is detected after the leverage ratio (along with other factors) is controlled for, however, will be more likely to reflect firm propensity towards (or against) tax planning.

One of the frequently cited papers on this still nascent research area is Adhikari, Derashid and Zhang,⁵⁶ which examines the link between ETRs and political connections for firms in Malaysia. The paper sets a provocative baseline for comparisons with subsequent research. The authors predict that firms with stronger political connections will display lower ETRs, by being able to lobby and obtain discretionary tax deductions and tax-free subsidies.⁵⁷ They find support for this prediction using two proxies for political connections, one being percentage of government ownership, the other being a measure (specifically developed in Malaysia) of the political connectedness of firm managers. Both measures are negatively connected with firm ETRs, after adjusting for firm size, sector and other effects.⁵⁸ Between the two proxies, the extent of state ownership is a stronger predictor of ETR than personal political connections. If

⁵⁵ Superior data has allowed some studies to adopt an even larger set of control variables, including size of majority shareholding, manager compensation, structures of the corporate board, etc. *See, e.g.,* Xing Liu 刘行 & Xiaorong Li 李小荣, 金字塔结构、税收负担与企业价值: 基于地方国有企业的证据 (Pyramidal structures, tax burdens and enterprise value: value based on local SOEs), 8 管理世界 (MGMT WORLD) 91, 91–105 (2012).

⁵⁶ Ajay Adhikari et al., *Public Policy, Political Connections, and Effective Tax Rates: Longitudinal Evidence from Malaysia*, 25 J. ACCT. PUB. POL'Y 5, 574 (2006).

⁵⁷ 56 at 577–79. Adhikari et al. claim to be agnostic about the specific mechanisms that produce lower ETRs for Malaysian SOEs and do not offer institutional details of the kind that we offered for China. 56 at 579 (footnote 9), 593–94.

⁵⁸ The authors do not control for the nominal tax rates to which the firms are subject, presumably because nominal tax rates (including legally provided tax preferences) do not differ between firms, other than perhaps as captured by sector effects.

interpreted as bearing on firm tax sensitivity, this Malaysian result presents a clear challenge to common intuitions: not only are SOEs not less tax sensitive than private firms, they are more tax sensitive!

Whether SOEs display higher or lower ETRs than private firms is a topic that received more direct attention and refinement in a number of recent studies in China. The first result to report is one that has been replicated in several papers, namely that Chinese SOEs that are owned by the central government bear similar or lower effective tax burdens when compared with non-SOEs. Cao, Liu and Zhang conducted a study of manufacturing firms listed on the Shanghai and Shenzhen stock exchanges for the years 2002 to 2005, and divided these firms into centrally-owned SOEs, locally- (i.e. sub-nationally-) owned SOEs, and non-SOEs.⁵⁹ They showed that for those firms that do not benefit from local tax preferences from the regions in which they operate, private firms have higher ETRs than centrally owned SOEs, and local SOEs have higher ETRs than both private firms and central SOEs.⁶⁰ Li and Liu examined all A-share listed companies for the years 1998 to 2010.⁶¹ In contrast to Cao, Liu and Zhang, they found no significant difference among the ETRs of centrally-owned SOEs and private firms;⁶² but they confirmed the former's finding that both types of firms display significantly lower ETRs than local SOEs.⁶³ These careful analyses rebut some other studies, based on similar data samples but empirically

⁵⁹ Shujun Cao 曹书军 et al., 财政分权、地方政府竞争与上市公司实际税负 (Fiscal decentralization, local government competition and effective tax rates of listed companies) 4 世界经济 (WORLD ECON.) 69–83 (2009).

⁶⁰ For firms that benefit from regional tax preferences, the authors find convergence in ETRs among all three categories of firms. The study controlled for sales, leverage, and ROA at the firm level, as well as for industry.

⁶¹ Liu & Li, *supra* note 55.

⁶² This could be the result not only of differences in their samples, but also of the fact that (i) Cao et al. used fewer firm-level control variables, but (ii) grouped firms into those that enjoy regional tax preferences (which generally produced convergence in ETRs) and those that do not. Cao et al., *supra* note 59. Liu & Li's finding of no differences among centrally-owned SOEs and private firms may be attributable partly to not filtering out the effect of regional tax preferences, which neutralize differences among firms. Liu & Li, *supra* note 55. Cao et al. argue that not considering this factor is a crucial drawback in prior research. Cao et al., *supra* note 59, at 72.

⁶³ This conclusion is also supported by Danglun Luo 罗党论 & Yuping Yang 杨玉萍, 产权、政治关系与企业税负——来自中国上市公司的经验证据 (Ownership, political connections and firm tax burden: empirical evidence from Chinese listed companies), 4 世界经济文汇 (WORLD ECON, PAPERS) 1 1–19 (2013).

less well designed (especially in failing to make the distinction between centrally- and locally-owned SOEs), that purported to find that Chinese SOEs in general display higher ETRs.

Thus for central SOEs, the Chinese evidence is consistent with the Malaysian study in Adhikari, Derashid and Zhang: there is no support for any prediction of lesser SOE tax sensitivity. What about Chinese local SOEs? Liu and Li suggest three reasons why local SOEs may be expected to bear higher tax burdens. First, Chinese local governments are engaged in intense competition over capital and other mobile factors. Such competition is costly from a fiscal perspective, and local governments must rely on immobile factors, including local SOEs, to absorb the costs of fiscal competition. In other words, their expectations of and efforts at revenue extraction from local SOEs are higher than from national SOEs and private firms. By comparison, the national government has no need to squeeze national SOEs, given large central government budget surpluses. Second, there is less information asymmetry between local governments and local SOEs (compared to non-SOEs and national SOEs), with the result that hiding income to avoid tax is not an option. Third, local SOE managers' compensation may not be tied sufficiently to firm performance and value, which also makes such managers less sensitive to the impact of taxes. It should be noted that Liu and Li make these observations not by reference to any theory of SOE taxation, but only to motivate their empirical strategy. But these explanations suggest that SOE ETRs are higher only when monitoring by the government shareholder is intense and when managers do not have incentives to maximize pre-tax returns in the first place. The third explanation, in particular, implies managerial aversion to tax, and that aversion increases with managerial incentives. The authors' explanations for high ETRs for local SOEs thus fit best with the forced distribution view of SOE taxation discussed in Part I, and not with the superfluity view.

Based on this reasoning, Liu and Li predict that greater enterprise autonomy and managerial incentives for local SOEs will lead to lower ETRs. As a proxy for such autonomy and increased incentives, they examine how many layers removed listed firms are from their ultimate owners—or how tall the “pyramidal structure” is above these firms.⁶⁴ Using a sample of all listed Chinese firms during the years 2004–2010, they find that locally owned SOEs’ ETRs are lower the further removed they are from their ultimate government owners. By contrast, for national SOEs and non-SOEs, the pyramidal structures above listed firms have no impact on company ETR. Moreover, the effect of pyramidal structures on ETR is accentuated in regions of China where government interference is considered heavier. Finally, they find that the reduced ETRs brought about by firms’ insulation from the ultimate government owners increase firm value. That is, investors in stock markets reward tax reduction that is brought about by greater autonomy and incentives of SOE managers, instead of reacting negatively to it because aggressive tax planning may in other contexts be associated with managerial misconduct. Overall, then, Liu and Li appear to discover that the more autonomous and profitable an SOE is, the less difference there will be between the SOE’s tax sensitivity and that of private firms.

In another recent innovative study, Luo and Yang find that firm ownership makes a difference not only directly to ETRs but also indirectly to the impact of political connections on ETRs.⁶⁵ They use an elaborate scale to measure the political connectedness of board presidents and CEOs of Chinese listed firms. They demonstrate that, as found by Adhikari, Derashid and Zhang for Malaysian firms, political connectedness helped to reduce firm ETRs during the 2004–2009 period. However, this benefit of political connectedness is most pronounced for non-SOEs,

⁶⁴ The use of this proxy for autonomy and incentives is justified by independent research reviewed by Liu & Li, *supra* note 55, at 94.

⁶⁵ Luo & Yang, *supra* note 63.

is somewhat less pronounced for local SOEs, and is not significant for central SOEs.⁶⁶ For local SOEs, this suggests that their managers are averse to tax (somewhat like private firm managers) and make efforts to reduce it. This is consistent with Liu and Li, and complements the evidence of central SOE lobbying reviewed in Part III. For central SOEs, the evidence suggests that their presidents and CEOs do not use their political connections to reduce tax. But we know this to be false, both because, as documented by Luo and Yang themselves and by other authors, central SOEs already enjoy the lowest ETRs of all firms, and because of the strength of the central SOE tax lobby discussed above. Thus other explanations may need to be sought: for example, that the presidents and CEOs of all listed central SOEs may be already so high on the political connections scale that there is not enough variation; or that listed firms constitute a biased sample as far as central SOEs are concerned. For instance, some of the most important preferences central SOEs obtain, such as marking up tax basis to appraised value without paying tax,⁶⁷ may have been obtained before—and precisely in anticipation of—their listings on stock exchanges.

B. Do SOEs Engage in Less Tax Planning?

Studying variations in ETRs while controlling for numerous firm characteristics is only one way to measure firm tax sensitivity. One could also try to measure the intensity of specific tax reduction efforts. For example, Shevlin, Tang, and Wilson studied a small sample of Chinese firms offering “B-shares” from 1999 to 2004.⁶⁸ They claim to identify a particular proxy for tax-motivated income shifting within a corporate group: firms may shift income to lower-taxed affiliates located in regions with tax preferences. They find that firms that use intangible assets

⁶⁶ The particular finding for central SOEs, that political connectedness has no significant impact on ETRs once state ownership is controlled for, is similar to the finding for Malaysian firms in Adhikari et al., *supra* note 56.

⁶⁷ See discussion *supra* Part III.B.

⁶⁸ Terry Shevlin et al., *Domestic Income Shifting by Chinese Listed Firms*, 34 J. AM. TAX’N ASS’N 1 (2012).

more intensively engage in more income shifting by this proxy, as do firms that have incentives to manage earnings before seeking new financing on equity markets. However, they find no difference between SOEs and private firms in their pursuit of income shifting. Moreover, although there was a significant change in the income tax sharing arrangement between central and sub-national governments in 2002, the degree of income shifting in SOEs did not change after 2002. These findings detract from the “superfluity” view of SOE taxation: SOEs are not found to be less tax sensitive, nor does the significance of SOE taxation change as a result of changes in revenue sharing arrangements.

A study by Cao, Liu and Zhang points to similar conclusions, finding that for Chinese listed firms that operate in regions not characterized by tax preferences, ETR generally is a positive function of the strengths of tax enforcement.⁶⁹ However, this positive relation is most pronounced for private firms, slightly less pronounced for central SOEs, and least pronounced for local SOEs. This is consistent with the general finding, discussed earlier, that local SOEs bear higher tax burdens than other firms. It suggests that central SOEs respond to the intensity of tax administration, which is incompatible with the hypothesis of SOE tax insensitivity.⁷⁰

More mixed evidence is presented in another study of A-share listed companies. Wang, Wang and Peng note first that, before the implementation of the new Enterprise Income Tax Law in 2008, when two different corporate income tax systems implied very different nominal tax rates for different firms, high-tax firms displayed a significantly higher level of leverage than low-tax firms.⁷¹ In other words, Chinese firms generally use interest expense deductions to shelter income (as do firms elsewhere). They then find that in 2008, when greater uniformity in

⁶⁹ Cao et al., *supra* note 59, at 79–80.

⁷⁰ Moreover, the authors find that central SOE ETRs are affected by the degree of government intervention, just as private firm ETRs are.

⁷¹ Yuetang Wang 王跃堂 et al., 产权性质、债务税盾与资本结构 (Ownership nature of ultimate controller, debt-related tax shields and capital structure), 9 经济研究 (ECON. RES.) 122 (2010).

tax rates was introduced, the level of borrowing also converged across firms: firms that saw tax rate decreases also decreased their levels of leverage, while firms that saw rate increases raised their levels of leverage. But the changes in level of borrowing (whether increases or decreases, in accordance with whether the firms were initially high-taxed or low-taxed) were more pronounced in private firms than in SOEs. SOE borrowing still changed in response to tax rate changes, but to a much less significant extent than private firms, suggesting that SOEs are less tax sensitive.⁷² The authors explicitly interpret this as evidence that SOEs are less aggressive in their tax planning.

The empirical accounting and corporate finance research reviewed in this section has emerged only in the last few years. Because of the sheer size of the Chinese state-owned sector, however, it is likely that this still nascent body of research, tracking the relationship between state ownership and tax profiles of Chinese firms, will soon reach a critical mass: more types of evidence regarding SOE tax sensitivity will be gathered, and the analysis of each type of evidence further refined. As it now stands, what is most striking is that there is at least as much evidence for the forced-distribution view of SOE taxation as there is for the view that SOEs are necessarily indifferent to taxation. This is remarkable because the researchers who have found quantitative evidence for tax sensitivity have generally not made reference to the forced-distribution view in making their empirical predictions, whereas the researchers finding evidence for indifference to taxation tend explicitly to endorse the proposition that SOE taxation is inherently different from the taxation of private firms. This, I believe, is because the latter view is much more entrenched. Thus even if many have held the empirical intuition that SOEs are highly tax-sensitive, the superfluity view may have suppressed such intuition. The theoretical

⁷² In this study, the authors did not distinguish between centrally- and locally-owned SOEs.

articulation of the forced distribution view, therefore, is important for guiding empirical research.⁷³

V. Conclusion

The forced-distribution view of SOE income taxation is closely intertwined with the study of corporate governance in SOEs, which forms the subject of numerous other chapters in this book. This view suggests that as a widely-adopted mechanism for forcing SOE distributions, taxation may have played an unrecognized, salutary role in disciplining SOE managers. To put it simply: if it weren't for the tax system, SOEs could have been even more unproductive. However, the prominence of SOEs has also importantly shaped—and often distorted—the development of the tax system, resulting in tax preferences and tax policy initiatives that could not otherwise have been expected.⁷⁴ Using the tax system to accomplish two drastically different purposes—to raise tax revenue from private firms, and to force distributions from SOEs—risks reducing the efficiency of the system in accomplishing its normal, revenue-raising objective. This begs the question of whether better mechanisms of corporate governance for SOEs can be found: might there be other feasible mandatory distribution mechanisms, for example?

Even if the preponderance of evidence from China turns out to support the forced distribution view, as a general theory of SOE taxation that view should be able to command empirical support (quantitative or otherwise) in other countries as well. Indeed, the forced distribution view may have empirical implications beyond firm-level tax sensitivity. For example, it seems to suggest that in countries where corporate governance problems for SOEs are less

⁷³ I attempt to offer such an articulation in Cui, *supra* note 3, Parts III and IV.

⁷⁴ A parallel may be found in the dilemma of imposing a single body of corporate legal norms on private and state-owned firms, discussed in Donald Clarke, *Chapter Name*, in *this volume*.

severe — however measured⁷⁵ — the reliance on, or effort devoted to, SOE taxation should also be more limited, again subject to the question of how that is to be measured.

Whether such empirical support is forthcoming is an open question. What must drive such empirical research, however, must be interest in the institutions of state ownership themselves. Such interest is perhaps more likely to be sustained by policy questions confronting those who have to live and work under such institutions—those who might find it difficult at least initially to abstract away from the circumstances (whether Chinese, Brazilian, Indian, Malaysian, or elsewhere) they are familiar with. Theorizing about state capitalism from within, however, precisely characterizes many of the other chapters in this book, and I am gratified that the topic of taxation has been included in the exercise.

⁷⁵ As Musacchio & Lazzarini suggest, this is not an easy question. See Musacchio & Lazzarini, *supra* note 8, at [pin cite].

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