TAX POLICY ISSUES IN EMERGING MARKET ECONOMIES

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Abstract

This paper examines a number of characteristics of East European economies—i.e., the degree of state ownership and public sector social expenditures—and considers the types of tax policies that would be appropriate for the immediate future. The conclusions are that the tax policies needed in these countries are quite different than those usually prescribed in developed countries and must be implemented quickly to avoid the financial collapse of the public sector. For many years, the income tax system will be largely irrelevant. Due to the very weak tax administration and the emerging private sector enterprises, the tax system must be very simple, yet with a number of built in constraints to curb tax evasion and avoidance.

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I: INTRODUCTION

The magnitude and speed of change in the organization of economic activities taking place in Eastern Europe is truly dramatic. But the efforts to date have been primarily to develop markets for the exchange of goods and services, not to change the ownership of the means of production. While privatization of state owned enterprises has been a goal of economic policy in many countries, including the former socialist countries of Eastern Europe, the outcome of such policies has usually been one of corporatization, or commercialization of the enterprises. In many cases this has involved a partial sale of enterprises to private interests through some type of joint venture arrangement.

Given the size of the state-owned sector in the former socialist countries, it is likely to be years, perhaps decades, before a majority of the industrial enterprises become entirely owned by the private sector. The most likely immediate outcome of the privatization effort is for these countries to move from a high degree of central direction of the enterprises to one of state-owned enterprises and joint private and state-ownership of firms operating in response to market signals. If this is to be the situation for the next five to ten years while the economy moves towards private ownership, then it is important that tax policies are designed to address the particular characteristics of these enterprises, not those of an economy of entirely privately owned firms.

Most countries that are primarily private sector oriented have either subjected their state-owned enterprises to the same tax on profits as private enterprises, or have exempted them completely from taxation. Seldom are state-owned enterprises taxed more heavily than their private sector counterparts. In mixed economies, the political forces often require the government to appear to treat its enterprises according to the same taxation rules as public enterprises. Usually in these countries, taxation of state-owned enterprises is taxation in theory, but not in results. Most state-owned enterprises have little or no taxable income and usually bear only a small fraction of the tax burden carried by their private sector competitors.

In the former socialist countries of Eastern Europe the experience has been quite different. Historically, the state-owned enterprises have been the primary source of taxation. Economic neutrality has seldom been an objective of these taxation systems. The primary objective has been to extract as much of the surplus from these enterprises as possible while allowing the enterprises to continue operation. This has usually meant levying a different tax rate on different types of activities, and in some cases, different firms.

The state-owned industrial sector has in many cases been essential to the tax collection mechanism. By keeping producer prices high, these enterprises accumulated large profits which were transferred to the central government. A significant proportion of these funds were then used to subsidize selected consumption items. By shifting to indirect taxation systems such as value added, excise, and direct payroll taxes these state-owned enterprises assist as withholding agents but their enterprise surpluses are greatly reduced.[1]

When privatization has been promoted it has usually been done by providing joint ventures with a tax system containing many incentives, but basically modelled on tax systems found in Europe. The goal has been to tax these market-oriented joint ventures and state-owned enterprises in a way that is similar to the tax system they would like to apply to privately owned business.[2]

As in many other real-world issues, appearances can be deceiving. While the legal systems applicable to public and private enterprises may be identical, a state-owned enterprise will experience a very different tax burden than does its private-sector counterpart. In this paper, the reasons for these divergent results will be outlined and a number of proposals are made that might assist in the development of an effective taxation system for

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[1] For example, in the early 1980s the "surplus" of the industrial sector in Hungary amounted to about 50 per cent of the GNP. By 1990 the industrial surplus had fallen to about 16 per cent of the GNP.

[2]. For a survey of the emerging tax systems in Eastern Europe see, Cheryl W. Gray, Tax Systems in the Reforming Socialist Economies of Europe, Working Paper #501, Country Economics Department, The World Bank, September 1990.

these economies.

II: INCOME TAXATION OF STATE-OWNED ENTERPRISES

A. Financial Structure

In the absence of economic externalities, efficiency in the use of the economy's available capital stock requires that the marginal before-tax rate of return on investment should be equalized across sectors. Of course, differential levels of undiversifiable risk associated with different activities should be reflected in their gross (before tax) rates of return; higher-risk sectors should yield higher rates of return in order for their net-of-risk rates of return to be equalized across sectors.

Such gross-of-tax rates of return should include the incremental income taxes paid by the firm, most if not all property taxes, and the fraction of sales and value-added taxes that have been paid on the value-added of capital. After these taxes have been paid, the private rate of return remaining is either paid to the shareholders through dividends, reinvested in the firm (retained earnings), or paid to the owners of the firm's debt. In many countries, the components that make up the before-tax rate of return of state-owned enterprises are similar to what one would expect in private enterprises. This, however, need not be the case.

Instead of requiring the state-owned enterprise to yield a given after-tax return while applying the general tax system to it, the government could give the state-owned enterprises an instruction to earn a before tax rate of return that was equal to that generated in the private sector. The dividend rate on government equity could be set high enough so that the combined before-tax rate of return in the private sector. Alternatively, a rule for reinvestment of profits could be written so that the dividend rate, combined with the rate of reinvestment and the interest rate paid on the debt, would be equal to that of the gross-of-tax rate of return generated by the private-sector industries.

Such dividend or rate of return rules are almost always ineffective. In the United Kingdom, during the 1970s there was a policy to set performance targets for their state-owned enterprises. Because the future cannot be predicted with any certainty, circumstances usually arise that provide the excuse for these performances targets not to be realized. Once the performance target is not attainable, then the sanctions for missing the target by a wide margin are usually not much more severe than missing it by a small amount.

The French Government has had a policy of negotiating performance contracts with many of their public enterprises. These contracts are very detailed and are very information intensive, and have the same defect as the targets used in the United Kingdom. Circumstances change, such as the increased oil prices during the 1970s and early 1980s, that make such forward-looking contracts inoperative.

In many countries state-owned enterprises are seen as an arm of the government department and a means for the bureaucracy to obtain funds for projects and activities that would not be funded by budgetary appropriations. In such a system, dividend payments to the Treasury are viewed as being an inferior use of funds by the enterprises and their home agency.

If correctly structured, the taxation system could be more effective as a way for the government to extract revenues from its investments than are systems of target rates of dividends negotiated by a particular Ministry. The taxation system has the advantage that its administration is generally applicable to both public and private firms, and backed up by a legal system. When it is the same individuals who administer the taxation of both private and state-owned enterprises, the administrative structure is usually not as sympathetic to deviant actions by state-owned enterprises as would a government department that only deals with public enterprises. The tax authorities must be seen to be even-handed in their treatment of private and state-owned enterprises. If the state-owned enterprise engages in activities that are contrary to the taxation laws set down by the government, then they come under the threat of sanctions which are both legally and socially more severe than those typically imposed on state-owned enterprises when they fail to meet certain targets or contracts with public organizations.

The taxation of the income of state-owned enterprises usually does not fail because of the administration of the tax, but such a tax system is often made ineffective because of the ways that these enterprises can legally reduce their taxable income.

Public enterprises around the world usually are financed by a larger proportion of debt than is the case for corresponding private enterprises. There are a number of reasons why this is the case. First, due to the difficulties of imposing dividend performance criteria, many governments prefer to finance new investments in state-owned enterprises with debt. The obligation of having to pay interest on a continuing basis is seen by governments as being a more effective way of forcing these enterprises to earn a return on their investments for the state than to give them a target rate of dividends to pay to the state. Second, state-owned enterprises have either an explicit or an implicit guarantee from the parent government on the debt which the enterprise borrows. Even in cases where there is no formal agreement by the central government to guarantee the debt of the state-owned enterprise, governments have usually provided an effective de facto guarantee.

Privatization efforts in the former socialist countries are now trying to follow the same pattern of debt structure for such enterprises. Attempts are being made in Hungary to have the partially privatized enterprises assume some of the national debt. By this means the Central Government believes that the enterprises would be more likely to generate sufficient surplus to cover these obligations than to distribute an equal amount of funds to the government as dividends for it to cover this debt service.

Because the debt of the state-owned enterprise has been viewed as sovereign debt, lenders have been willing to provide much more debt to a state-owned enterprise than to a private enterprise with the same value of assets. This has serious implications for the application of a private sector oriented income tax system.[3] In fact, government owned enterprises have little or no "true debt" in a commercial sense. The debt of these enterprises has the commercial characteristics that are close to those preferred shares issued by the private sector.

In the determination of taxable income in a Western style tax system, almost all countries allow interest to be deducted from income in order to arrive at taxable income. When the firm has a higher proportion of debt, than its interest expenses will be higher, relative to profits, and as a result, it will pay a smaller amount of income tax. If all interest on debt is deductible, the state-owned enterprise will end up having a smaller stream of taxable income than would a private enterprise with the identical stream of income measured gross of interest expenses and taxes. This results in a smaller amount of taxes being collected from the state-owned enterprise than would be collected from a private-sector enterprise with the identical sales, operating costs, production, and asset base.

The tax liabilities of state-owned enterprises tend also to

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be lower than their private-sector counterparts because they are usually not required to generate as high a rate of return gross of tax on their equity base as are private enterprises. Because private enterprises do not have the same sovereign guarantee of their debt, they cannot borrow to finance new investments with the same ease as can the state-owned enterprise. As a result, they must finance their new investments through a mix of both equity financing and debt financing. If such an enterprise is to go to the capital market, it must have an earnings performance on its equity that will attract new investors. In order to have this track record on dividends and earnings, they would have to pay income taxes. Because this market discipline is not imposed on state-owned enterprises, they are able to operate with a lower profit stream, and hence, a smaller base for taxable income.

If a government wants to tax state-owned enterprises and private enterprises on a more equitable basis, it must build provisions into the taxation system that would correct for the different financing opportunities of these two types of corporations. Such corrections are routinely made in calculating the taxable income of foreign-owned subsidiaries or branches.

A single foreign branch or subsidiary obtaining financing through its foreign parent is in much the same position as is a state-owned enterprise when it obtains financing from the government, or uses a government guarantee to obtain funds from the private sector. Investments of the foreign subsidiary can be financed either by equity or debt from the parent. For commercial purposes equity and non-arm's-length debt from the parent are essentially identical. The implications, however, for the tax system are quite different. If the subsidiary is financed by equity and wishes to pay dividends abroad, then it will have to pay income taxes, and usually withholding taxes, to the host country. If the same investments are financed by debt from the parent, then it gets to deduct the interest from taxable income in the host country. In addition, interest payments abroad often receive favorable withholding-tax treatment.

In order to prevent the erosion of the corporate tax base in the host country, many of these countries have tax rules to limit the amount of interest that can be deducted form taxable income. These rules are commonly called "thin capitalization rules". The most common rule is to stipulate that none of the interest paid on subordinated debt or not-arm's-length debt can be deducted from taxable income.

In the case of multinational corporations, it is very difficult to determine what debt is in fact arm's-length, and which is borrowed on a non-arm's-length basis. Debt coming to a subsidiary may appear to be borrowed on a non-arm's-length basis from a bank, but in fact is guaranteed by a parent or subsidiary off-shore. Because of these difficulties, sometimes more arbitrary rules are required in order to preserve the host country's tax base.

Another version of such a rule is to disallow the deduction of interest on any debt that would put the financing of the company's assets over a certain ratio. This is the type of rule found in many of the foreign investment contracts in Indonesia, and in its income-tax law of 1983. Another rule to limit the amount of deductible interest payments is simply to define taxable income as a percentage (k) of taxable income before deducting interest from all sources. A version of this rule has been imposed recently by the United States (IRC, Section 163 (j) 1989) to restrict the amount of interest expense that certain foreign owned affiliates operating in the United States can deduct for purposes of U.S. taxation.[4]

An attraction of the latter rule is that it reduces the marginal tax rate to the fraction (k) of the statutory tax rate. If income is increased by a new investment, taxation is not affected by the way the new asset is financed. The additional income is in fact taxed at the same rate, whether is used to pay interest or to pay dividends or create retained earnings. In this way, the incentive in the tax system towards financing assets through debt is eliminated.

In the case of public enterprises, the government may wish to finance these enterprises with debt in order to force them to earn a positive rate of return. The taxation rule that simply applies the corporate income tax to a given percentage (k) of the value of

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[4] United States, Internal Revenue Code, Section 163 (j), as amended 1989. The U.S. rule is to restrict the amount of interest expense deductible in a given year to 50 percent of taxable profits as measured before the deduction of interest expense. Excess interest expense can be carried forward to future taxable years.

the taxable income gross of interest expense still allows the government to finance the corporations using debt without affecting the amount of tax being collected. In this way, it can attain both the objective of forcing the corporation to pay a positive return for its capital and require it to pay its share of the corporate income tax.

This type of tax system does not give the corporations as much relief during periods of economic downturn. Under normal conditions, profits can go to zero as soon as the interest expense is equal to the value of profits before deducting for interest. In the case of a private corporation, it might be perceived as being unduly harsh not to allow a full deduction for interest. However, this is not the situation for state-owned enterprises. Because they are part of the public sector, they do not have the same probability of suffering the consequences of bankruptcy. Requiring them to pay taxes, even though their interest expense is equal to their taxable income before deduction of interest, does not result in their suffering undue damage. In fact, much of this interest expense would have been taxable profits if the firm had been privately owned.

B. Taxation of Fringe Benefits

In the former socialist countries fringe benefits from employment is a primary way of rewarding managers. With the move from centralized control to mixed state and private ownership there is a strong tendency to have the enterprises continue to bear the cost of benefits such as cars, houses, vacations and various consumer items. These items have been generally deductions from enterprise's taxable income.

Because of the large proportion of the remuneration received by many people through this channel, it would be very disruptive to tax the individuals on the benefits they receive. In addition, it is almost impossible to place an accurate figure on the value of these fringe benefits to the workers. A preferred option is to levy a fringe benefits "excise" tax on the costs of providing these items at the firm level. This tax should be at the same rate as the highest marginal individual tax rate. In this way the firms will have an option to continue paying for these fringe benefits or simply pay wages and salaries.[5] The transitional cash flow costs will be borne by a few firms rather than by many workers. The valuation of the fringe benefit costs will also not need to be done so accurately as it is the average costs of these items that is important from the firm's point of view, not the valuation from

[5] This type of tax system has been implemented in New Zealand and Australia. See Government of New Zealand, New Zealand Income Tax Legislation, Section 336N, April 1985; Government of Australia, Taxation Laws Amendment Fringe Benefits and Substance Act 1987.

the point of view of a particular worker.

III: <u>TAX-LOSS UTILIZATION AND STATE-OWNED ENTERPRISES</u>

Under the normal tax regime, where state-owned enterprises are taxed in the same way as private enterprises, we find that they usually do not pay very significant amounts of taxes because they have proportionally larger interest deductions. As a consequence, when there are other incentives, the state-owned enterprises will generally quickly be in a non-taxpaying position, and will end up accumulating significant banks of unutilized tax deductions. These tax deductions will often be much larger than would be found in comparable privately-owned organizations.

It is important to recognize that in countries such as Canada, the United Kingdom, or the United States, a significant proportion of firms [thirty to fifty per cent] will not be taxable in any given year. The firms that are investing rapidly in areas which receive either accelerated depreciation or investment tax credits are likely to operate with tax losses, even though they are financially profitable. Hence, the accumulation of unused "banks" of tax deductions is a frequent phenomenon.

The former socialist countries also are following this path. In each country the corporation income taxes have provided generous incentives for particular activities that will quickly lead to unused banks of tax losses.

The occurrence of accumulated tax deductions that cannot be used by firms leads to pressures on the government to devise schemes which allow the use of these deductions, either by individuals or by other taxable firms. The leasing arrangements in the United States that were implemented in 1981 and 1982, or the Canadian Research and Development tax credit of 1984, or the flow-through shares and limited partnerships which are found in several countries, are all financing vehicles to facilitate the flow-out of tax losses from taxpayers that have no taxable income to taxpayers that have taxable income and can therefore use the losses to reduce their taxable income. If the state-owned enterprises are not restrained from using such flow-out vehicles, the government will find that if it provides a new opportunity for the transfer of such accumulated deductions to other taxpayers, the state-owned enterprises will be the principal actors in such schemes.

In Canada, Petro-Canada and the Canadian Development Corporation were major actors in the use of term-preferred shares. When the Research and Development tax credit was introduced, the government-owned aircraft builders were major beneficiaries. The result is that under current taxation arrangements, the state-owned enterprises pay much lower taxes than do private enterprises when they are profitable. At the same time, state-owned enterprises are able to use the various tax-shelter arrangements to a greater degree than other corporations and, hence, receive greater than normal benefits from their tax losses.

In the design of a tax system for state-owned enterprises, considerable thought must be given to restraining these enterprises from using the tax system simply as a way of obtaining indirect subsidies from the government. It is likely that tax incentives play a smaller role in investment decisions of state-owned enterprises than is the case for private enterprise. This is largely because of other controls which the government might have that affect their investment decisions. As a result, the revenue loss to the government per unit of additional investment will likely be larger for state-owned enterprises than for private firms. Their excessive use of tax shelters is simply a way to circumvent the normal budgetary controls under which they should operate.

The creation of after-tax financing schemes by state-owned enterprises makes it more costly for governments to provide tax incentives to promote investment or some other activity through the private sector. It is recommended, therefore, that the tax laws explicitly rule out the use of such schemes by any enterprise that is more than ten to fifteen percent owned by a government or statutory body. If the fundamental problem of thin capitalization affecting taxable income is addressed as recommended in Section II, the problem of overuse of after-tax financing will be largely eliminated. The incidence of unused tax losses would be dramatically reduced, therefore reducing the incentive for employing after-tax financing instruments to raise funds.

IV: INDIRECT TAXATION AND STATE-OWNED ENTERPRISES

Indirect taxation, in most circumstances, is a more cost-effective means of collecting government revenue than is an income tax or other forms of taxation. The indirect taxes tend to be either of a sales-tax form, and levied either at the manufacturing or retail level, or of the value-added tax form.

Indirect taxes represent a tax on both the value-added or labor and the value-added of capital. The value added of capital in this case would include the yield from capital that is paid out in the form if interest as well as the dividends and retailed earnings.

The former socialist countries all have either introduced value added taxes or are planning to do so. There is, however, a difficult tax-policy issue of what should and should not be covered by the tax. For example, in Hungary there are numerous exemptions and over 40 zero rated categories for items that are defined to be public services, but in most other countries would be privately supplied goods and services and would be subject to value added taxation. In combination with a high rate of value added tax, this tax treatment provides a powerful disincentive for privatization if it is thought that these goods and services would become taxable if produced by a private business.[6]

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[6] "Turnover Taxes", in Republic of Hungary, International Bureau of Fiscal Documentation", Supplement No. 16, May 1990, p. 69.

Faced with much the same dilemma, the Government of New Zealand decided to tax all of the public sector on its value added in exactly the same way as the private sector is taxed.[7] In this way the disincentive of the value added tax system toward privatization of many of these activities in the future is eliminated.

V: PRIVATIZATION AND PENSION REFORM

Privatization of state-owned enterprises and the transfer of large amounts of the ownership of these assets to pension funds are two actions that should take place at the same time in the former socialist countries. No mixed economy can possibly maintain a strong enough tax system to pay full pensions for everyone out of government revenues while allowing the ownership of enterprises to be held by the private sector. Nor would it be consistent with the existence of private employment. Pensions are, in the most part, deferred compensation for activities performed. Under the present arrangement for pensions in Eastern Europe, a very large part of the future pension obligations to be borne by the government would be for work that will be provided to the enterprises being privatized. Hence, these liabilities should be the obligations of the private enterprises.

In developed countries pension funds are an integral part of

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[7] Government of New Zealand: Peter Barrand, "The Taxation of Non-Profit Bodies and Government Entities" in Conference Volume Administrative Aspects of a Value Added Tax, Washington, D.C. October 11-12, 1990.

the private capital market. Their portfolios of assets represent a large fraction of the total debt and equity of private sector enterprises. The development of a set of private pension plans in Eastern Europe and funding them now for the past service pension credits of their members, provides an ideal avenue for privatizing a large part of the state-owned sector in these countries. These pension funds should under normal regulation be allowed to buy and sell financial assets, hence, would be an important element of long term financing in the development of a sound capital market. They also provide a means for a rapid achievement of the broad based ownership of privatized enterprise by ordinary citizens.

Under the present system where the government owns all enterprises, it is feasible to have all pensions paid by a central authority. For both financial and institutional reasons, however, such a system is unlikely to work effectively in an economy that has significant private sector activity. For example, in Hungary the state-owned enterprises pay social security taxes that are about 2.4 times their corporation income tax payments plus dividends. Part of this is a tax to cover the costs of pensions and the rest to cover other medical care costs.

As this is a tax there is no action that the enterprise can take to either reduce these expenditures through efficiency measures or to link these expenditures to the welfare of their employees. This is simply an inefficient, and perhaps impossible, way to organize the provision of pensions and social welfare activities in a mixed economy. Privatization of the state controlled industrial sector must be accompanied by privatization of a large part of the pension obligations of government in these countries in order to avoid either fiscal cı or to avoid the impoverishment of the elderly.

VI: CONCLUSIONS

To ensure that state-owned enterprises generate a rate return approximately equal that of other private-sectc enterprises, they must be required to pay similar effective rate of tax as do private enterprises. In order to have a viable taӿ system for state-owned enterprises, such a system must limit the deductibility of the interest expense of these firms. State-owned enterprises should also be restricted in their use of particular tax incentives that are designed for private enterprises. In order to control and reverse the tendency of paying compensation to managers in the form of tax free fringe benefits, a special excise tax should be placed on the expenditure by the enterprises (both for profit and non-profit enterprises) of these items. In addition, the goods and the services produced by the public sector as well as state-owned enterprises should bear indirect taxes at the same rate as do the goods and services produced by the private ector. Finally, the privatization of the industrial assets of the ıblic sector in these countries should be accompanied by the velopment of funded pension plans in order to provide for the tirement income of the employees of these enterprises.

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