HKUST IEMS
INSTITUTE FOR EMERGING MARKET STUDIES

JULY • 2020 | No. 39

THOUGHT LEADERSHIP BRIEF

KEY POINTS

- Offshore tax evasion and avoidance represent a serious threat to the financial and reputational integrity of the BRI.
- Most BRI countries are not party to either of the two global standards for financial and tax transparency, which leaves them particularly vulnerable to the threat.
- China's single-minded focus on reducing tax frictions for BRI cross-border investment has led it to emphasize other tax priorities rather than financial and tax transparency, further exacerbating the threat.
- China should give high priority to financial and tax transparency in BRI countries, and lead the way by going beyond the two global standards wherever appropriate, such as through public disclosures and extensive non-reciprocal sharing of information.

The Belt and Road Initiative and the Ticking Time Bomb of Offshore Tax Evasion and Avoidance

Michael Tyrala

Photo by Josh Appel on Unsplash

Issue

Since its announcement in 2013, the Belt and Road Initiative (BRI) has come to represent many things to many people. To Chinese leaders, it is the embodiment of the kind of openness, cooperation, and shared growth that will guarantee China's peaceful rise. To those more wary of this rise and of whether it will really be peaceful, it is nothing less than a state-backed campaign for global hegemony that is all about strategic leverage, economic penetration, and cultural dominance abroad, while addressing industrial overcapacity at home. Simplistic narratives aside, the BRI is undeniably a monumental undertaking that has the potential to fundamentally transform the global investment and trading landscape, and to significantly expand China's political, economic, and cultural influence around the world, which naturally makes it a threat to many powerful interests.

Determined to turn this potential into reality, China has already invested around $300 billion in the BRI and is eager to invest considerably more in the coming years. However, for an undertaking of such scale and ambition to succeed, especially under what are likely to be increasingly hostile conditions, financial commitments will not be enough. China will also have to learn lessons from its record of unforced errors and preventable public diplomacy nightmares, several of which have already resulted in major setbacks to the BRI, with concerns around debt, corruption, and environmental sustainability serving as prime examples.

In commentary on the BRI, offshore tax evasion and avoidance get much less attention than those examples, but they are closely intertwined with all three, and given the sheer volume of cross-border investment involved in the BRI, they are just as important, and potentially just as damaging. According to even the most conservative estimates, global tax revenue losses from offshore tax evasion amount to around $200 billion annually, and from offshore tax avoidance to around $100-240 billion annually. (Zucman 2015; OECD 2015) To illustrate this in a way particularly pertinent to the BRI, consider that nearly 40% of all foreign direct investment (FDI) comes in the form of "phantom FDI", the primary purpose of which is not genuine investment, but rather the minimization or even outright elimination of the global tax bills of wealthy individuals and multinational enterprises (MNEs). (Damgaard et al. 2019)

The impacts of offshore tax evasion and avoidance are not confined to just tax revenues. They also exacerbate income and wealth inequality, pervert market competition, undermine macroprudential supervision, and incentivize inefficient allocation of debt. The consequences are borne by populations everywhere, but those from developing countries are hit disproportionately hard. This makes BRI countries particularly vulnerable and leaves China particularly exposed to further criticism should scandals emerge.

In the analysis that follows, I argue that another major setback to the BRI looming on the horizon pertains to offshore tax evasion and avoidance, and that the only way for China to avert or at least mitigate this threat is to put in place preventive measures that meet or ideally even exceed current global or regional standards.

Assessment

Unfortunately, the prospects of such change in policy happening anytime soon are not very promising given China's poor record in combating offshore tax evasion and avoidance. For example, dating back to at least the 1990s, China has been contending with the issue of round-tripping, a method by which domestic capital flees the home country and then flows back disguised as FDI, whether for the purpose of money laundering, circumvention of regulations, access to favorable tax rates and tax incentives, or other advantages. According to what is still one of the most comprehensive studies on the topic to date, around 40% of China's outward FDI was estimated to be due to round-tripping, which itself accounted for only about a quarter of China's overall capital flight. (Xiao 2004) Another issue China has been contending with is trade misinvoicing, a method of moving money illegally across borders by deliberately falsifying the price, quantity, or type of goods or services in an international commercial transaction, for purposes very similar to round-tripping, and likewise amounting to hundreds of billions of dollars over the decades. On top of all this, China has featured prominently in the 2013 Offshore Leaks and the 2016 Panama Papers, with the former even prompting a separate series of investigations known as the "China Leaks", which revealed offshore dealings of top Chinese leaders, business tycoons, and high level executives of state-owned enterprises from virtually every corner of China's economy, including BRI mainstay sectors such as mining, petroleum, green energy, and shipping. In recent years, Chinese authorities have ramped up efforts to crack down on capital flight, but numerous loopholes still remain, and offshore practitioners continue describing China as one of the top sources of growth in demand for offshore services, often specifically citing the BRI as an exceptionally promising opportunity.

China has been more active in the global regulatory arena as a member of the newly empowered G20, which tasked the OECD with addressing offshore tax evasion and avoidance. Upon coming to terms with the fact that existing international tax rules were themselves a part of the problem, the two organizations embarked on the most far-reaching reform of the international tax system to date. Overall, the reform process has rightly been criticized as more of a patch-up exercise than the fundamental change that has so sorely been needed to effectively tackle offshore tax evasion and avoidance, but it is ongoing, and the one key area in which it has already resulted in genuine progress has been that of financial and tax transparency, where two new global standards have been developed.

The first one is the 2014 Common Reporting Standard (CRS) for Automatic Exchange of Financial Account Information in Tax Matters, which requires signatory jurisdictions to obtain a range of financial account information from their respective financial institutions including banks, insurance companies, brokers, custodians, and even various investment vehicles, and annually exchange that information with other relevant signatory jurisdictions.

The second one is the 2015 Country-by-Country Reporting (CbCR) filing obligation, which requires all MNE groups with annual consolidated revenue of $850 million or more to provide aggregate information on the global allocation of income, profit, and taxes paid, as well as certain indicators of the location of economic activity for each of the tax jurisdictions in which the groups operate. The report is then annually shared with other relevant signatory jurisdictions.

While neither of these global standards is without flaws, they make for a powerful deterrent, and provide signatory tax administrations with a much clearer view of the financial and tax maneuverings of individual and large corporate taxpayers. As such, they serve as the first line of defense against offshore tax evasion and avoidance. However, the devil is in the details, and the most important detail here is that in order to begin exchanging CRS and CbCR information, signatories also go through an arduous bilateral negotiations phase which determines their exchange relationships, or in other words the signatories they send information to, and receive information from. The more exchange relationships are formed, the stronger the system is, but the phase leaves considerable room for delayed or even mock compliance.

To its credit, China has been an early adopter of both these standards, but the same cannot be said of many BRI countries. As seen in Table 1, of the 146 BRI jurisdictions (counting mainland China, Hong Kong, and Macau separately), only a fraction have established at least one active CRS or CbCR exchange relationship, and a large proportion of that fraction were EU and/or OECD member states. Thus, the developing countries most at risk from offshore tax evasion and avoidance and most in need of the information are left out of the loop.

Table 1: BRI Jurisdictions Exchanging CRS and CbCR Information (as of 26th November 2019)

CRS	CbCR
59/146 BRI Jurisdictions (of which 23 are EU and/or OECD)	**37**/146 BRI Jurisdictions (of which 21 are EU and/or OECD)

Source: (OECD 2019; 2019a)

The situation is revealed to be even worse upon scrutinizing the exchange relationships of mainland China, Hong Kong, and Macau. As the preeminent BRI jurisdictions, it would be reasonable to expect them to be at the forefront of financial and tax transparency promotion within the BRI, but as seen in Table 2 and Table 3, that has not been the case at all.

Table 2: CRS Exchange Relationships of Mainland China, Hong Kong, and Macau with BRI Jurisdictions (as of 26th November 2019)

Mainland China	
Sending Information To **35**/145 BRI Jurisdictions (of which 20 are EU and/or OECD)	**Receiving Information From** **47**/145 BRI Jurisdictions (of which 22 are EU and/or OECD)
Hong Kong	
Sending Information To **31**/145 BRI Jurisdictions (of which 21 are EU and/or OECD)	**Receiving Information From** **40**/145 BRI Jurisdictions (of which 23 are EU and/or OECD)
Macau	
Sending Information To **31**/145 BRI Jurisdictions (of which 20 are EU and/or OECD)	**Receiving Information From** 0 Jurisdictions

Source: (OECD 2019)

Table 3: CbCR Exchange Relationships of Mainland China, Hong Kong, and Macau with BRI Jurisdictions (as of 26th November 2019)

Mainland China	
Sending Information To **21**/145 BRI Jurisdictions (of which 17 are EU and/or OECD)	**Receiving Information From** **24**/145 BRI Jurisdictions (of which 20 are EU and/or OECD)
Hong Kong	
Sending Information To **27**/145 BRI Jurisdictions (of which 19 are EU and/or OECD)	**Receiving Information From** **34**/145 BRI Jurisdictions (of which 21 are EU and/or OECD)
Macau	
Sending Information To 0 Jurisdictions	**Receiving Information From** 0 Jurisdictions

Source: (OECD 2019a)

Moreover, the information exchange coverage has been inconsistent and slow to materialize even among mainland China, Hong Kong, and Macau themselves. To date, Macau has not established any active exchange relationships with either mainland China or Hong Kong, and the CRS and CbCR exchange relationships between mainland China and Hong Kong have only been active since September 2018 and March 2020 respectively, although the latter arrangement is retroactive.

The BRI information exchange coverage is unlikely to be drastically improved anytime soon, because China's single-minded policy focus has been on reducing tax frictions for BRI cross-border investment, while the threat of offshore tax evasion and avoidance along with the immense financial and reputational damage it poses to the BRI has essentially been ignored even though the two priorities need not be at odds with each other. This focus has been evident in virtually every tax-related activity pursued by China within the BRI context to date, including its tax administration overhaul, the themes of the high level international tax conferences it has organized, and the kind of tax support it has pledged to BRI members. Most importantly, during the April 2019 launch of the Belt and Road Initiative Tax Administration Cooperation Mechanism (BRITACOM) and the adoption of the Wuzhen Action Plan (2019-2021), raising tax certainty, expediting tax dispute resolution, enhancing tax administration capacity, and streamlining tax compliance were all prioritized, but financial and tax transparency did not even get a perfunctory mention. This is a costly mistake that is only bound to grow costlier for both China and the BRI, but it is far from irremediable.

Recommendations

While offshore tax evasion and avoidance are complex problems that require a multilateral systemic solution, there is plenty that China could do unilaterally with a relatively high degree of effectiveness and at a relatively low cost. China should make financial and tax transparency a priority, and start by extending its CRS and CbCR information exchange coverage, especially with BRI countries, and most appropriately under the auspices of the BRITACOM. China could pursue different options, depending on whether it chose to lead the way, meet current global or regional standards, marginally improve on the status quo, or a combination thereof.

China could lead the way by publically disclosing all CbCR information, which would contribute to significantly better tax administration supervision, public accountability, and investment decisions. Public disclosure of all CbCR information is already being seriously considered by the EU, and has for years been a standard in some regions for MNEs in certain high risk sectors, for example in the extractive sectors in the EU and Canada, and in the financial services sector in the EU. Should China be reluctant to move to full public CbCR, it would do well to at least meet the existing sectoral standards, especially given the high frequency of BRI projects in these high risk sectors. Alternatively, China could find some middle ground by extending the coverage to its own selection of sectors or actors.

China could also lead the way by offering to send its CRS and CbCR information to the tax administrations of all relevant and interested BRI members on a non-reciprocal basis. This is already happening in the other direction, with both mainland China and Hong Kong receiving information from more jurisdictions than they are sending information to. Reciprocal information exchanges would still be actively pursued, but some developing countries simply lack the necessary infrastructure and resources to effectively reciprocate, and until they were able to do so, non-reciprocal sharing would contribute to extending reporting coverage and thus make everyone including China better off than before. Relatedly, to the extent that China has already pledged its support to tax administrations of BRI countries, it could provide support for building the infrastructure necessary for reciprocation.

Finally, should China be reluctant even in this regard, it could at the very least be more active in pursuing bilateral negotiations on information exchange with different countries, and also support BRI countries that have little to no negotiating leverage of their own in their efforts to strike information exchange agreements with developed countries.

The bottom line is that the benefits of financial and tax transparency far outweigh the potential costs. China has little to lose and a lot to gain by demonstrating leadership in this area.

Michael Tyrala is a Postdoctoral Fellow at the Institute for Emerging Market Studies of the Hong Kong University of Science and Technology. His research interests lie at the intersection between international relations, political economy, and historical sociology. He focuses on the global offshore nexus between high net worth individuals, multinational enterprises, tax havens, and the professional intermediaries that facilitate their interactions; on the various political, economic, and socio-cultural forces that struggle against this nexus; and on the impacts of these struggles on the structural dynamics that constitute the capitalist world-economy. In 2016, he completed an internship with the Trade Union Advisory Committee to the OECD, during which he drafted two official publications on reforming the international tax system. Shortly after, he was awarded the 2016 TTN Tax Prize. His most recent contribution was submitted to the Special Forum on Samir Amin's Proposal for a Fifth International, and subsequently published in a special issue of the journal Globalizations.

Read all HKUST IEMS Thought Leadership Briefs at

http://iems.ust.hk/tlb

HKUST IEMS
INSTITUTE FOR EMERGING MARKET STUDIES

T: (852) 3469 2215

E: iems@ust.hk

W: http://iems.ust.hk

A: Lo Ka Chung Building,
The Hong Kong University
of Science and Technology,
Clear Water Bay, Kowloon

With support from

EY 安永
Building a better working world

Acknowledgement

This research is supported by the Strategic Public Policy Research Funding Scheme from the Central Policy Unit of the Hong Kong SAR Government.

Visit http://iems.ust.hk/bri-sppr for details.