NEWS AND ANALYSIS

How China Could Stymie A Global Tax Deal

The G7's agreement on international taxation was groundbreaking — and a major win for Biden. But China could still water down the deal's impact.

BY KATRINA NORTHROP — JUNE 27, 2021

By Kat via Flickr

The G7's groundbreaking agreement on international taxation, brokered at its meeting in the UK earlier this month, has received plaudits from many quarters. But one country that will be critical to making the plan a reality has remained notably silent: China.

The reticence among leaders of the world's second-largest economy should come as little surprise. The deal, initially struck by finance ministers from seven advanced economies including the U.S. and Japan, could threaten Beijing's long-favored tactic of using corporate tax breaks to support particular industries and regions. The Chinese government may also be wary of handing the Biden administration — for whom a global tax deal has been a priority — a major diplomatic victory.

"China can't be expected to cozy up to the U.S. on international tax the way American allies do," says Wei Cui, a professor of tax law at the University of British Columbia and author of *The Administrative Foundations of the Chinese Fiscal State*. "China faces the situation where it wants to embrace multilateralism, but it doesn't have the same incentives to give Biden a win because it doesn't get anything in return."

For sure, most analysts expect China eventually to sign on to the tax deal, which could be finalized at October's meeting of the Group of Twenty leading nations. The proposal's two main pillars are that companies will have to pay taxes in the countries where they sell products and services, not where they are headquartered; and the enforcement of a global minimum tax rate of 15 percent, which is designed to stop countries from lowering corporate tax rates to attract multinationals.

But there's concern, too, that China will use detailed negotiations between G20 finance ministers on the deal in July to water down its impact.

"The devil is all in the detail — what will the minimum [corporate tax] rate be, but also what will the exact design look like and so on, and that still needs to be settled," says Rasmus Corlin Christensen, a postdoctoral researcher at the Copenhagen Business School and the author of a recent paper on China's role in international tax governance. "China will absolutely seek to represent its interest to secure carve-outs or exemptions, allowing them to continue to offer the tax incentives they have used aggressively as part of their broader economic policy paradigm."

On paper, the new global minimum tax rate shouldn't be a problem for China, whose corporate levy rate currently stands at 25 percent — just above the OECD average of 23.5 percent, and the U.S.'s current 21 percent level.

China's central government isn't overly reliant on corporate tax: it accounted for 23.6 percent of the tax revenue in 2020, according to Cui's calculations. Value-added tax (VAT), a consumer tax on goods and services, is more important, accounting for nearly two-fifths of fiscal income last year. While in the U.S., individual income taxes are the largest source of income, at 41 percent, they make up just 7.5 percent of China's revenue.

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— *Wei Cui, a professor of tax law at the University of British Columbia and author of The Administrative Foundations of the Chinese Fiscal State.*

Yet corporate tax remains a vital economic policy tool in China. The government has long implemented tax breaks for companies located in special economic zones, most recently in the island province of Hainan. It has also cut taxes for companies in strategic industries, like quantum computing or artificial intelligence, or those involved in cutting pollution.

Another issue for China could be the position of Hong Kong, long a low-tax haven for companies and individuals alike, where the corporate tax rate is now just 16.5 percent. "Hong Kong being a tax haven allows China to have higher tax rates. If you remove this pressure valve, there may be more pressure for China to have lower taxes," says University of British Columbia's Cui.

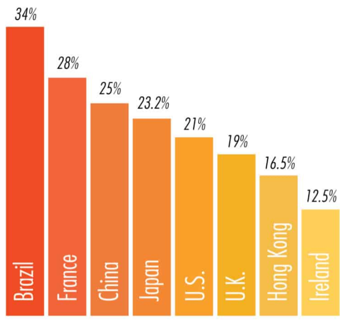
The upshot is that China, along with low corporate-tax nations like Ireland, may well push for concessions to allow it to continue to offer tax incentives or to set up low-tax zones.

That could in turn create a major sticking point for the deal: Michael Graetz, a professor of tax law at Yale Law School says it's unlikely the U.S. will agree to meet all of China's demands.

"The U.S. or Europe is not going to say that they will make an exemption for China's high tech companies," says Graetz. "If China believes that they will do that, they are not living in reality." Indeed, U.S. Treasury Secretary Janet Yellen said last week that she would not agree to any carve-outs for China that would weaken the deal.

Corporate Income Tax

With its corporate tax rate slightly above the OECD average, China uses tax breaks as an economic policy tool.



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China's position on reallocating tax revenue to countries where companies make their sales is likely to be more mixed. China has a huge domestic market, so would likely welcome the right to tax foreign multinationals that sell in China. But it may be reluctant to give away taxing rights over the extensive overseas operations of Chinese companies, particularly in the tech sector.

On this point there may be more common ground between the U.S. and China, says Christensen at the Copenhagen Business School, as both are home to large tech companies that have become expert at using offshore havens to reduce their corporate tax bills. He says it's unclear whether or not China would gain or lose in terms of tax revenue from changing the current system.

"We don't have any public estimates, so it's hard for me to say. It would depend on the details of the agreement as well," he says. "I'm not sure if the added revenue from foreign companies selling into the Chinese market would outweigh the revenue lost from its domestic internationalizing companies."

On the broader geopolitical level, China is also conflicted. Chinese officials want to show that they are constructive players in multilateral negotiations like the G20; but they don't want to allow other countries to interfere with China's domestic tax policy, nor do they wish to bolster the Biden administration too much.

"For strategic reasons, China might want to use its leverage not to give in so easily," says Henry Gao, a law professor and Chinese trade expert at Singapore Management University. "I can see them making a fuss about simple issues to show it's not a pushover."

Asked at a recent press conference whether China will support the G7 agreement, Foreign Ministry spokesperson Wang Wenbin dodged the question and instead reiterated the importance of including the broader G20 group in negotiations. "China believes that all countries including G20 should contribute in a pragmatic and constructive manner, properly handle the major concerns of all sides, and demonstrate inclusiveness in the design of the solution," Wang said. *The Wire* reached out to the Treasury Department for comment, but did not receive a response in time for publication.

There is still a long way to go before this deal is on the books. Next, the G20 and the 139 countries involved in talks hosted by the OECD will have to agree to the deal. It is still unclear when the regulations will finally be implemented.

"The G7 can't decide these things on their own. It's a misunderstanding of the process to say the G7 decides," says Christensen, at the Copenhagen Business School. "It does matter a lot that China has a chance to have a say here. It's not just these old powers from Europe and the Americas."

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BY EYCK FREYMANN

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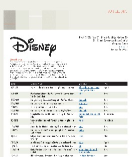

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