

Martin Hearson and Wilson Prichard

China's challenge to international tax rules and implications for global economic governance

**Article (Accepted version)
(Refereed)**

Original citation:

Hearson, Martin and Prichard, Wilson (2018) China's challenge to international tax rules and implications for global economic governance. [International Affairs](#), 94 (6). pp. 1287-1307. ISSN 0020-5850

DOI: <https://doi.org/10.1093/ia/iyy189>

© 2018 The Authors. Published by Oxford University Press on behalf of The Royal Institute of International Affairs.

This version available at: <http://eprints.lse.ac.uk/90641>

Available in LSE Research Online: November 2018

LSE has developed LSE Research Online so that users may access research output of the School. Copyright © and Moral Rights for the papers on this site are retained by the individual authors and/or other copyright owners. Users may download and/or print one copy of any article(s) in LSE Research Online to facilitate their private study or for non-commercial research. You may not engage in further distribution of the material or use it for any profit-making activities or any commercial gain. You may freely distribute the URL (<http://eprints.lse.ac.uk>) of the LSE Research Online website.

This document is the author's final accepted version of the journal article. There may be differences between this version and the published version. You are advised to consult the publisher's version if you wish to cite from it.

China's challenge to international tax rules and implications for global economic governance

Martin Hearson^a and Wilson Prichard^b

Martin Hearson and Wilson Prichard. China's challenge to international tax rules and the implications for global economic governance, *International Affairs*, Volume 94, Issue 6, 1 November 2018, Pages 1287–1307, <https://doi.org/10.1093/ia/iyy189>

^a *Department of International Relations, London School of Economics and Political Science*

^b *Munk School of Global Affairs, University of Toronto; International Center for Tax and Development; Institute of Development Studies*

China's challenge to international tax rules and implications for global economic governance

Twentieth century institutions of global economic governance face a profound challenge adapting to the rise of emerging markets, especially China. This is especially the case for an international tax regime based on norms that favour capital exporting states, and whose institutional home is the OECD. To understand the nature of the challenge posed by China, we focus on its engagement with a foundational norm of the international tax regime: the arm's length principle (ALP). We show that China's approach to tax cooperation is characterised by a set of apparent contradictions: conciliatory language hides an assault on the ALP; rhetoric of common cause with developing countries is contradicted by actions that maximise only China's own share of the tax 'pie'; a willingness to court the OECD relies on the leverage gained from flirtation with outside options. In these respects China appears increasingly to be using its market power to seek special privileges within international regimes, in ways that mirror the historical actions of the United States.

Keywords: China, foreign direct investment, global governance, OECD, taxation, emerging markets

Word count: 10,164

Introduction

How will the rise of China and other large emerging markets affect the liberal economic order created in the last century, largely by OECD states? Will existing institutions of economic cooperation be transformed to accommodate rising powers, embraced by them in their existing form, or fall by the wayside? This puzzle has motivated a vibrant strand of international relations scholarship in recent years.¹ With a predominant focus on trade governance, as well as on the global system of reserve currencies and the overseas development aid architecture, this literature appears to be settling on a consensus that China is a cautious reformist, rather than seeking more dramatic change.² Nonetheless,

¹ See eg: Miles Kahler, “Rising powers and global governance: negotiating change in a resilient status quo”, *International Affairs* 89: 3 (2013), pp. 711–29; Matthew D. Stephen, “Emerging Powers and Emerging Trends in Global Governance,” *Global Governance*, Vol. 23 (2017): 483–502; Françoise Nicolas, “China and the Global Economic Order: A Discreet Yet Undeniable Contestation,” *China Perspectives*, Vol. 2 (2016): 7–14; Naná De Graaff and Bastiaan Van Apeldoorn, “US–China Relations and the Liberal World Order: Contending Elites, Colliding Visions?,” *International Affairs* 94, no. 1 (2018): 113–31; Amitav Acharya, “Can Asia Lead? Power Ambitions and Global Governance in the Twenty-First Century,” *International Affairs*, Vol. 87, No. 4 (2011): 859; Xingye Jin, David Daokui Li and Shuyu Wu, “How Will China Shape the World Economy?” *China Economic Review*, Vol. 40 (2016): 272–280.

² See, eg: Jing Gu, John Humphrey, and Dirk Messner, “Global Governance and Developing Countries: The Implications of the Rise of China,” *World Development* 36, no. 2 (2008): 274–92; Yang Jiang, “China’s Pursuit of Free Trade Agreements: Is China Exceptional?,” *Review of International Political Economy* 17, no. 2 (2010): 238–61; Kristen Hopewell, “Different Paths to Power: The Rise of Brazil, India and China at the World Trade Organization,” *Review of International Political Economy* 22, no. 2 (2015): 311–38. See, eg: Peter Ferdinand and Jue Wang, “China and the IMF: From Mimicry Towards Pragmatic International Institutional Pluralism,” *International Affairs*, Vol. 89, No. 4 (2013): 910; Hai Yang, “The Asian Infrastructure Investment Bank and Status-Seeking: China’s Foray into

various observers have noted increasing deadlock on the global stage arising from the proliferation of divergent preferences in global forums.³

However, by focusing on a cross-cutting narrative, this emerging consensus does not help us to understand how Chinese strategies may vary across issues areas and over time.⁴

The impact of China's rise in a given area of global economic governance will be influenced by three variables: the distribution of interests between states that determines the lines of conflict and cooperation, the determinants of state power and their distribution, and the problem structure of the issue in question. Interacting with each of these is change over time. The changing distribution of economic power is a dynamic process that interacts with profound changes underway in the nature of economic production, trade and capital flows. Countries' interests in this environment are not static, but evolving, just as are their capabilities.

We illustrate this schema using an area of global economic governance that has been frequently overlooked in international relations scholarship, but has become increasingly politicised in recent years: international taxation, and in particular, the division of multinational firms' taxable profits between states. China's interests in this area are described by Chinese officials as 'unique and inimitable', as they are rapidly shifting from those of a capital importer and low value-added manufacturer towards those of a capital exporter with aspirations in high value-added industries, and a large consumer

Global Economic Governance," *Chinese Political Science Review*, Vol. 1 (2016): 754-778.
Shahar Hameiri and Lee Jones, "China Challenges Global Governance? Chinese International Development Finance and the AIIB," *International Affairs* 94, no. 3 (2018): 573-93; Rosemary Foot and Andrew Walter, "Global Norms and Major State Behaviour: The Cases of China and the United States," *European Journal of International Relations* 19, no. 2 (2013): 329-52.

³ Stephen, "Emerging Powers and Emerging Trends in Global Governance"

⁴ One of the few attempts to compare across issue areas is Foot and Walter, "Global Norms and Major State Behaviour."

market. This defies traditional dividing lines between capital-exporting OECD states and capital-importing developing countries. Turning to the determinants of power, China's growing and profitable market, as well as its critical place within global value chains, allows it to chart its own path without fear of market sanctions that less powerful countries might face from unilateral actions. Pulling against these dynamics is a constant: the nature of the issue area itself. This area of tax cooperation is a coordination game with distributive conflict, which is characterized by very strong pressures for global cooperation.⁵ This distinguishes tax from the issue areas that have dominated the existing literature on China in global governance, which have tended to be prisoner's dilemma issues with stronger incentives for states to defect.

The consequence is a distinct set of Chinese strategies, which may reveal much about the evolution of both international tax debates and China's broader global ambitions. On one hand, China has engaged actively with existing, and historically western-led, institutions of global tax governance, offering vocal support for an unprecedented reform of international tax rules led by the OECD. On the other hand, within those negotiations China has adopted a quietly aggressive stance, launching a subtle, but profound, challenge to OECD orthodoxy through the concept of 'Location Specific Advantages' (LSAs), which allows it to secure an expanded share of global tax revenues. Presented as a narrow intervention in a highly technical debate, LSAs in fact represent a potentially profound challenge to OECD orthodoxy, and reveal China's growing power and assertiveness in seeking to shape global economic governance within multilateral fora. Meanwhile, behind a rhetoric of solidarity with developing countries, China has increasingly appeared to pursue its narrow national self-interest, which diverges from that of economies with less market power. This Janus-faced approach to tax cooperation mirrors the historical actions of the United States.

⁵ Thomas Rixen. *The Political Economy of International Tax Governance*. New York: Palgrave Macmillan, 2008

The remainder of the paper begins with a review of the literature on China's role in global economic governance. Section three then discusses the institutions of international tax cooperation, introducing the 'Arm's Length Principle' (ALP), on which the analysis is focused. The following two sections turn to analyzing China's engagement with the reform of international tax rules, with a focus on its advocacy for reliance on 'Location Specific Advantages' in allocating taxing rights across countries. The final section concludes.

China, global economic governance and international taxation

A growing literature has asked whether major emerging markets economies are likely to cooperate with existing institutions of global economic governance, or adopt a more conflictual stance. China is seen as having been comparatively cautious, neither playing a major agenda-setting role nor seeking to make the system more inclusive for developing countries writ large, despite its rhetoric.⁶ Several explanations have been offered: lack of consensus on a new national role, 'pre-emptive restraint' to avoid a backlash which could threaten its economic growth, a desire for sovereignty and independence, and limited domestic capacity to coordinate among interest groups and government institutions.⁷

⁶ Much of the research on China's relationship to developing countries has focused on development financing. For instance, China's One Belt One Road initiative explicitly lays out that Chinese financing is the servant of national strategy, rather than purporting to serve other developing countries. Hongying Wang and Erik French, "China in Global Economic Governance," *Asian Policy Review*, Vol. 9 (2014): 254-271. See also David Murphy, "One Belt One Road: International Development Finance with Chinese Characteristics," in *Pollution*, ed. Gloria Davis, Jeremy Goldkorn, Luigi Tomba (Canberra: Australian National University Press, 2016): 249-250.

⁷ Jörn-Carsten Gottwald and Sebastian Bersick, "The Domestic Sources of China's New Role in Reforming Global Capitalism," *International Politics*, Vol. 52, No. 6 (2015): 779. Acharya, "Can Asia Lead?"; Hopewell, "Different Paths to Power"

Perhaps most studied has been China's engagement with the WTO, where it has moved cautiously, while broader disagreements amongst key WTO members have contributed to deadlock.⁸

That said, China has become more ambitious over time, sometimes adopting regional strategies that circumvent – but do not directly confront – existing western-led institutions. From the 2000s, following its accession to the WTO and the Asian financial crisis, China is argued to have shifted from a 'learning' mode to one characterised by strategic interventions in areas of particular importance.⁹ In turn, recent accounts have highlighted China's pursuit of "dual-track" strategies: working both within and around existing western-led institutions.¹⁰ China has responded to WTO deadlock both by cooperating and by expanding regional economic integration, such as the Belt and Road Initiative.¹¹ Similarly, China has championed parallel institutions to the IMF and World

⁸ Eg. Gu et al, "Global Governance and Developing Countries"; Jiang, "China's Pursuit of Free Trade Agreements"; Hopewell, "Different Paths to Power"

⁹ Gregory Chin & Ramesh Thakur (2010) *Will China Change the Rules of Global Order?*, The Washington Quarterly, 33:4, 119-138; Margaret M. Pearson, "The Major Multilateral Economic Institutions Engage China," in A.I. Johnston and Robert S. Ross, eds., *Engaging China: The Management of an Emerging Power* (New York: Routledge, 1999), pp. 207—234; Alastair Iain Johnston, "Is China a Status Quo Power?" *International Security* 27, no. 4 (Spring 2003); Nicholas Lardy, *Integrating China into the World Economy* (Washington, D.C.: Brookings Institution Press, 2002).

¹⁰ Li Yamin and Wang Hao, "China and Emerging Economies in Global Financial Governance: Legitimacy, Accountability and Democracy," *Journal of Shanghai Jiaotong University (Science)*, Vol. 21, No. 2 (April 2016): 200.

¹¹ Ferdinand, Peter, "Westward ho—the China dream and 'one belt, one road': Chinese foreign policy under Xi Jinping", *International Affairs*, Vol. 92, No. 4 (2016): 941-957

Bank – the New Development Bank and the Asian Infrastructure Investment Bank – that nonetheless fit alongside existing bodies, rather than challenging them directly.¹²

While this literature provides a persuasive description of the status quo, two forward-looking questions demand further consideration. The first is the possibility of sharp differences in Chinese strategies across issues areas, dependent on three things: economic interests, power dynamics and problem structure. China may seek cooperation in some issue areas alongside conflict in others, while developing tailored strategies to pursue its national interests. So called “dual-track” strategies have reflected this diversity, as China has sought to cooperate globally while acting more unilaterally at the regional level. Yet these “dual track” strategies in relation to trade and development finance reflect particular combinations of interests, capabilities and problem structures.

The second question relates to changes over time: while China has played a cautious role to date, how likely is this to persist into the future? Changes in the global economy are driving intertwined shifts in China’s interests and its global influence. Whereas rapid growth was initially built on large inflows of FDI to support low value-added manufacturing, China became a net capital exporter in 2016 – and is now the third largest capital exporter in the world. Official government policy is now focused on supporting a shift toward higher technology and higher value-added economic activities. These shifts are likely to reshape China’s global interests as well as its capability to further them.

The case of international tax rules sheds light on both questions, and challenges common narratives in the existing literature. Contrary to the prevailing sense of growing deadlock in global institutions, tax cooperation has recently seen multilateral cooperation unprecedented in its depth and breadth. This has been led by the Base Erosion and Profit Shifting (BEPS) project, launched in 2012 by the G20 and OECD, the recommendations

¹² New Chinese aid institutions, for example, regularly reference the Bretton Woods organisations, and seek to highlight their shared core principles.

from which have been endorsed by well over 100 countries. In turn, China's interests and negotiating power around international tax rules are rapidly shifting. Its crucial position in global value chains has progressively increased its negotiating power, while a shift toward capital exports and a focus on high value-added activities predicts a realignment of its interests away from maximizing the taxation of multinational firms operating in China toward supporting Chinese multinationals investing abroad – potentially aligning it more closely with OECD countries.

Meanwhile, the nature of the global cooperation problem differs from much of the existing literature. In contrast to widely studied trade negotiations, international taxation presents significantly stronger incentives for global consensus on rules, making them relatively resistant to “dual track” strategies.¹³ Yet the global tax landscape also remains characterised by significant distributional conflict.¹⁴ The next section elaborates.

The arm's length principle, international tax soft law and developing countries

“International tax rules” refers not to hard law codified in a global treaty, but a set of general principles and guidelines that have evolved over the past century to guide taxation of businesses operating across borders. These ‘rules’ have nonetheless taken on the power of widely accepted soft law, almost universally followed in setting national policies and adjudicating international disputes.¹⁵ In turn, the norms underpinning

¹³ Rixen. *The Political Economy of International Tax Governance*.

¹⁴ Richard Eccleston and Helen Smith, “The G20, BEPS and the Future of International Tax Governance” in Dietsch and Rixen (eds), *Global Tax Governance*.

¹⁵ Avi-Yonah, Reuven S, *International Tax as International Law* (New York: Cambridge University Press, 2007); Eduardo Baistrocchi, ‘Tax Disputes under Institutional Instability: Theory and Implications’, *The Modern Law Review*, 75 (2012), 547–77

international tax rules have remained remarkably stable since the early twentieth century, even as periodic reforms refresh their application.

International tax rules seek to address a simple question: how should the right to tax the global profits of multinational companies (MNCs) be divided across countries, while also preventing tax avoidance and evasion that exploits gaps and mismatches between national tax systems? Absent coordination, both sets of undesirable outcomes are likely: in some cases ‘double taxation’ by respective governments, each trying to claim a larger share of the tax ‘pie’, will deter cross-border investment, while multinational firms will in other cases exploit gaps in the system to reduce the overall taxes they pay. This is a classic coordination problem: there are powerful in-built incentives for states to organize themselves around a shared set of rules and practices, despite distributional conflict over their details.¹⁶ Given these characteristics, the adoption of a set of common rules by economically powerful OECD countries has historically dictated their adoption by other states, who otherwise risk exclusion from global economic networks.¹⁷

A foundational principle of OECD soft law is the *arm’s length principle* (ALP), which says that, to divide the profits of an MNC across countries for tax purposes, its subsidiaries should be treated *as if* they were unrelated economic entities. Profits are allocated between subsidiaries by pricing transactions between them *as if* those same transactions were undertaken between unrelated economic actors at market prices. The

¹⁶ Thomas Rixen, ‘From Double Tax Avoidance to Tax Competition: Explaining the Institutional Trajectory of International Tax Governance’, *Review of International Political Economy*, 18 (2011), 197–227; Rixen, *The Political Economy of International Tax Governance*; Radaelli, “Game Theory and Institutional Entrepreneurship”

¹⁷ Philipp Genschel and Thomas Rixen, ‘Settling and Unsettling the Transnational Legal Order of International Taxation’, in *Transnational Legal Orders*, ed. by Terence C. Halliday and Gregory Shaffer (New York: Cambridge University Press, 2015); Allison Christians ‘Global Trends and Constraints on Tax Policy in the Least Developed Countries’, *University of British Columbia Law Review*, 42 (2010), 239

OECD argues that as long as those internal transactions are priced appropriately, the ALP offers a technocratic and unbiased approach to dividing profits. In the words of OECD secretariat staff: “The arm's length principle is sound in theory since it provides the closest approximation of the workings of the open market.”¹⁸ The ALP thus aims to remove explicit distributional conflict from multilateral discussions.

In practice, however, the ALP has become a lightning rod for criticism, much of it focused on whether the ALP may implicitly or explicitly disadvantage developing countries, thus challenging claims of distributional neutrality.¹⁹ The first reason is the difficulty of enforcing the ALP in developing countries, which under OECD rules requires finding ‘comparable’ open market transactions for internal transactions within an MNC. This approach offers MNCs significant scope to set transfer prices high or low in ways that artificially shift profits into low-tax jurisdictions, especially in areas such as trade in intangible assets – most notably intellectual property and expertise – for which no comparable open market transactions may exist. Policing these transfer prices is difficult enough for OECD tax administrations, and near impossible for many developing country tax authorities. The latter lag behind both on administrative capacity and access to information about comparable market transactions. The end result is rules that, whatever their theoretical appeal, in practice undermine collection in poorer countries.

¹⁸ Joseph L Andrus, Mary C Bennett, and Caroline Silberztein, ‘The Arm’s-Length Principle and Developing Economies’, *Tax Management Transfer Pricing Report* (Washington: Bloomberg BNA, 2011), 495

¹⁹ Tim Buttner and Matthias Thiemann, ‘Breaking Regime Stability? The Politicization of Expertise in the OECD G20 Process on BEPS and the Potential Transformation of International Taxation’, *Accounting, Economics, and Law: A Convivium*, 7 (2017); Matti Ylönen and Teivo Teivainen, ‘Politics of Intra-Firm Trade: Corporate Price Planning and the Double Role of the Arm’s Length Principle’, *New Political Economy*, 2017, 1–17

Recent estimates suggest that the impact of MNC profit shifting on tax revenues is about twice as large in developing countries, as a share of GDP.²⁰

A second area of criticism proposes that the OECD's interpretation of the ALP naturally advantages capital exporting countries, and owners of intellectual property, while disadvantaging capital importers. Under OECD guidelines profit is allocated across countries, through the system of transfer pricing, based on the assumed value-added of different activities within the global value chain. In practice, the guidelines allow MNCs to treat their routinized manufacturing activities in developing countries as low value-added, assigning them a correspondingly small share of global profits. MNCs naturally prefer to assign as much value as possible to the owners of intellectual property and services, primarily in the OECD countries among which the rules were developed and where they are headquartered, or in tax havens. Emerging markets and their allies contend that the OECD approach allows firms to undervalue the activities that tend to occur in developing countries, thus denying them their rightful share of global profits and tax revenues.²¹

These critiques are reinforced by the risk of more powerful states defecting from the OECD guidelines and defining national rules that give them a larger share of the tax base. For the most part the incentives to conform exceed those to defect, but larger, more economically powerful countries have at times successfully adapted the rules in their favor. Illustratively, when the United States adopted new transfer pricing rules at the turn of the 1990s, commentators quickly identified the revised rules as a political move to

²⁰ Cobham, Alex, and Petr Jansky. 2018. "Global Distribution of Revenue Loss from Tax Avoidance: Re-estimation and Country Results." *Journal of International Development* 30(2):206-232

²¹ United Nations, *Practical Manual on Transfer Pricing for Developing Countries*, First edition (United Nations, 2013) chapter 10.

claim a greater share of the global tax base.²² This forced other OECD states to decide whether to accommodate US changes or risk double taxation, and subsequent negotiations saw compromise rules adopted into the OECD guidelines, as other states acquiesced to US economic power and effectively granted them a larger share of the global ‘tax pie’.²³

Against this background, the OECD, with endorsement from the G20, launched what came to be known as the BEPS project in the aftermath of the global financial crisis of 2008-09. The unprecedented reform program aimed to “ensure that profits are taxed where economic activities generating the profits are performed and where value is created,” with the arm’s length principle near the heart of the discussions.²⁴ While driven by tax concerns within OECD countries, the process involved broad global consultations, with the OECD presenting itself not as a representative of OECD states, but as a convening body, consulting globally, and directed by the more representative G20. Ultimately, the BEPS final reports and recommendations, published in 2015, amounted to the most significant proposed revisions to international tax rules in at least a generation, with over 100 countries signing the shrewdly-titled ‘Inclusive Framework’ on BEPS, which has since begun to be implemented around the world.

However, despite some significant initiatives, the BEPS proposals failed to fully address the concerns of developing countries and large emerging markets, including China.²⁵ Most critically to the discussion here, the OECD actively defended OECD guidelines on

²² Radaelli, “Game Theory and Institutional Entrepreneurship”

²³ *ibid*

²⁴ OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD Publishing, 2013).

²⁵ Independent Commission on Aid Impact, “UK Aid’s Contribution to Tackling Tax Avoidance and Evasion,” 2016.

ALP, resisting pressure for the exploration of more effective and equitable options.²⁶ BEPS thus made adjustments to the international tax regime that met the needs of OECD member states, while leaving unresolved some of the tensions between its members and other countries.²⁷

China's rapidly evolving interests and influence

The traditional dividing line in international tax debates has been between those that export capital (historically, OECD countries) and those that import it, with the latter constrained by the OECD's guidelines on applying the ALP. Historically, China was easily placed in the latter group, but it increasingly defies easy categorization: it officially became a net capital exporter in 2016,²⁸ but also remains a major recipient of inward investment.

China's correspondingly shifting interests can be seen in relation to bilateral tax treaties, which translate OECD soft law into hard law. These treaties broadly serve to constrain the taxing rights of capital importing countries. However, there have historically been two global models, maintained by the OECD and UN, with the latter imposing fewer restrictions on capital importing developing countries. In its earliest negotiations, China was willing to accept treaties with OECD members on their terms, despite the fiscal

²⁶ Tim Buttner and Matthias Thiemann, 'Breaking Regime Stability? The Politicization of Expertise in the OECD G20 Process on BEPS and the Potential Transformation of International Taxation', *Accounting, Economics, and Law: A Convivium*, 7(1), 2017; Wouter Lips. "Great powers in global tax governance: a comparison of the US role in the CRS and BEPS", *Globalizations*, 2018.

²⁷ Taxation of the digital economy, the most contentious issue among OECD members themselves, was also left unresolved.

²⁸ World Bank. World Development Indicators.

costs, in order to send the signal that it was open to investment.²⁹ However, in subsequent treaties with OECD countries it has used its growing power to successfully push for clauses from the UN model treaty that expand its taxing rights. For example, not only was its 1986 tax treaty with the United States the first to be signed by a US President rather than a lower-ranking diplomat, it was also “particularly generous” towards China, so much so that the US Senate Foreign Relations Committee included a disclaimer in its official report that the treaty could not act as a precedent for subsequent negotiations with other countries.³⁰ Meanwhile, China’s tax treaties with recipients of its foreign direct investment have moved in the opposite direction, as it has become more aggressive than OECD countries themselves in negotiating advantageous clauses with less developed countries.³¹ This Janus-faced stance has been unique to China, and not shared to the same extent by other BRICS negotiators in their treaty negotiations with developing countries.³²

These competing impulses are indicative of the need to step beyond the traditional capital importer/exporter dichotomy in analysing China’s interests. The Chinese State Administration of Tax (SAT)’s view is set out in a book chapter written by two of its senior officials.³³ The officials emphasise China’s unique characteristics as a developing country, but also argue that its position in the world economy is changing, and with it

²⁹ Eduardo Baistrocchi, ‘The International Tax Regime and the BRIC World: Elements for a Theory’, *Oxford Journal of Legal Studies*, 33 (2013), 733–66

³⁰ Paul D Reese ‘United States Tax Treaty Policy Toward Developing Countries: The China Example’, *UCLA Law Review*, 35 (1987), 369-397, p386

³¹ Jinyan Li, ‘The Great Fiscal Wall of China: Tax Treaties and Their Role in Defining and Defending China’s Tax Base’, *Bulletin for International Taxation*, 66 (2012), 452–79

³³ Tizhong Liao and Li Hanli, ‘China: International Taxation in the Post-BEPS Era’, in *Asian Voices: BEPS and Beyond*, ed. by Sam Sim and Mei-June Soo (Amsterdam: IBFD, 2017), pp. 123–30

China's tax priorities. They identify four such shifts, set out in Table 1, which also constitute four axes of conflict between states. China expects in the future to become a net exporter of capital, to move its comparative advantage from low-skilled towards high-skilled labour, to become increasingly driven by domestic demand – driving a shift in its current account towards more imports and fewer exports – and to upgrade its position in global value chains towards high-skilled high-value added research and development.

Table 1: Changes in China's economic position emphasised by SAT officials

Economic shift		Implied change in tax cooperation objectives
1	Capital-importing to capital-exporting	Reduce the overseas tax burden of Chinese investors
2	Factor-driven to innovation-driven	Increase share of tax base from intellectual property development and royalties
3	World factory to world market	Increase share of tax base from marketing activities
4	From modernisation of manufacturing to full value-chain modernisation	Increase share of tax base from research and development

Source: Liao & Hanli, 2017

These shifts explain China's changing interests around international taxation. In the past China's interests were closely aligned with other developing countries, with a focus on how to effectively tax subsidiaries of multinational enterprises in China. In the future its interests appear set to more closely resemble those of capital exporting, high value-added OECD countries. In the present it faces the need for policy solutions that meet both needs at once: satisfying its immediate revenue needs as a major recipient of low valued-added foreign investment, while ensuring that those same rules will provide maximum future benefits to Chinese firms investing overseas, and increasingly focusing on intellectual property and other intangibles. "China was a factor-driven economy. China is now an

efficiency-driven economy. And China will quickly become an innovation-driven economy,” its most senior international tax official told a conference in 2017.³⁴

China’s interests are changing, but what about its influence over international tax rules? China has a particularly strong position in international tax negotiations because the same economic transition that is changing its preferences is also strengthening demand from multinational firms to access its markets. This perspective differs from those such as Lukas Hakelberg who, building on Daniel Drezner, equate power in the taxation of multinational companies with market size.³⁵ As China’s share of inward and outward FDI stocks is an order of magnitude lower than those of the US and EU, Hakelberg concludes that it cannot be regarded as a ‘great power’.

We take a different view. Power in the double taxation regime begins from autonomy, the ability to break with the multilateral consensus without fearing negative investor reaction.³⁶ Absolute market size understates this form of power because it omits three important variables: growth, profitability and integration into global value chains. First, growth. China is undergoing huge economic and social shifts that make it a uniquely attractive place to do business. By one measure its middle class already spends more in total than that in the US,³⁷ and its consumer market growth, at six percent per year, far

³⁴ Quoted in Mark Melnicoe, “Liao: International Tax Rules Must Adapt to China’s Rise,” *Transfer Pricing Report* 24 (2015): 685.

³⁵ Lukas Hakelberg, “Coercion in International Tax Cooperation: Identifying the Prerequisites for Sanction Threats by a Great Power.” *Review of International Political Economy* 23.3 (2016): 511–541. Web.

³⁶ In the context of bond markets, Layna Mosley refers to this as ‘Room to Move’. See Layna Mosley ‘Room to Move: International Financial Markets and National Welfare States’, *International Organization*, 54 (2000), 737–73

³⁷ Homi Kharas, *The Unprecedented Expansion of the Global Middle Class: An update*, Brookings Institute Working Paper 100, February 2017, p16.

outstrips Western countries.³⁸ Meanwhile, as it upgrades its position in value chains, China is predicted to overtake the US as the world's largest source of patent applications by 2020.³⁹ China's attraction to investors is thus about future potential as well as present performance. Second, profitability: this relatively new and rapidly growing consumer market is relatively untapped in many areas, has a taste for foreign goods and services, and its likely to be more willing to pay a premium for higher quality products as disposable income increases.⁴⁰ Together with China's continued position at the top of manufacturing competitiveness rankings,⁴¹ investments in China are attractive and profitable propositions in the present day. Third, value chain positioning: Chinese manufacturing has become indispensable to the production of a huge proportion of products consumed in the West, most iconically the iPhone, a position that is becoming increasingly institutionalized through specialized regional manufacturing hubs, in which "China is turning scale-driven specialization into a persistent competitive advantage."⁴² These three types of advantages give China some room to impose moderate increases in tax costs – such as those multinational firms might incur when a country deviates from rules based on the international consensus – without jeopardizing its competitive position.

³⁸ World Economic Forum and Bain & Company, *Future of Consumption in Fast-Growth Consumer Markets: China*, Geneva, January 2018.

³⁹ World International Patent Organisation, *China Drives International Patent Applications to Record Heights; Demand Rising for Trademark and Industrial Design Protection*. Press release, March 21, 2018

⁴⁰ World Economic Forum and Bain & Company, *Future of Consumption in Fast-Growth Consumer Markets*

⁴¹ Deloitte, *2016 Global Manufacturing Competitiveness Index*, London: Deloitte Touche Tohmatsu Limited, 2016. China was ranked in first position from 2010 to 2016 and is forecast to be in second position in 2020.

⁴² Gereffi, G. and Lee, J. (2012), "Why the World Suddenly Cares About Global Supply Chains", *Journal of Supply Chain Management*, 48: 24-32

Having considered China's interests and its ability to make policy autonomously, the third part of our schema concerns the problem structure of international taxation. Unlike areas such as international finance, where power-as-autonomy does not necessarily translate into power-as-influence,⁴³ large states that are willing and able to act unilaterally have disproportionate influence in the international tax regime. This is because of the powerful incentives for global consensus, to avoid the proliferation of multiple standards that might create double taxation. This gives states with large market power significant leverage over the OECD countries who designed the present day consensus. Much like the US in the 1990s, Chinese unilateralism puts pressure on other states to reach accommodations to avoid the emergence of double taxation.

Location specific advantages: China's challenge to the ALP

China has faced a unique challenge in seeking to pursue its complex, rapidly changing interests on the global stage. The fragmented nature of bilateral treaties allowed it to pursue different strategies in different contexts, and to leverage its economic power in bilateral negotiations. By contrast, being brought inside the multilateral BEPS process has required China to navigate its changing and competing interests within a single set of global negotiations, while defending its position in the face of opposition from the bulk of the OECD at once. The most visible and central aspect of this complex positioning is in China's approach to the ALP. Publicly, it has remained a steadfast supporter of the OECD BEPS process, through which the ALP retains its place at the heart of global tax rules. Yet more quietly it has progressively advanced a substantial challenge to OECD orthodoxy.

⁴³ Eric Helleiner and Stefano Pagliari. "The End of an Era in International Financial Regulation? A Postcrisis Research Agenda." *International Organization* 65, no. 1 (2011): 169-200

The most authoritative statement of China’s view on the ALP is found not in its own domestic tax regulations, but in the ‘Country Practices’ chapter of a United Nations publication, the Practical Manual on Transfer Pricing, published in 2013, and updated in 2017. Although China elaborated new transfer pricing regulations in 2016 and 2017, they did not contain specific rules on the matters discussed in this article, and so the UN manual remains the most authoritative and detailed statement of the SAT’s position.⁴⁴ As three tax practitioners from law firm Baker Mackenzie wrote in an industry journal soon after the first edition was published:

Although China is just beginning to revamp its transfer pricing practices, it has already made a big splash internationally with the China Chapter of the UN Manual. The response to the UN Manual has been far greater than expected, with numerous articles, seminars and client meetings discussing its principles.⁴⁵

In the first edition, SAT officials frame China’s position as follows: “As a developing country, China faces a number of difficult challenges, to many of which ready answers have not been found from the OECD guidelines.”⁴⁶ In the 2017 edition, written after the BEPS process had concluded, they add that “China needs to strike a balance between conforming to international conventions and acknowledging its unique situation in transfer pricing legislation and practice.”⁴⁷ In similar fashion, the Chinese representative to an OECD led consultation on March 19, 2015 argued bluntly that the arm’s length

⁴⁴ Peng, “A Rethink of Location-Specific Advantages with an Analysis of the Chinese Approach,” *International Transfer Pricing Journal* 2017, November/December: 482–502.

⁴⁵ S. Yuan, J. Liu & G.R. DeSouza, “Changing Transfer Pricing Landscape: ‘Like It or Not’”, *International Transfer Pricing Journal* 20, no. 4 (2013), 252-262.

⁴⁶ Tizhong Liao and Xiaoyue Wang, “China Country Practice,” in *Practical Manual on Transfer Pricing for Developing Countries*, First edition (United Nations, 2013) p375.

⁴⁷ Xiaoyue Wang, Yimin Sun, and Hanli Li, “China Country Practice,” in *Practical Manual on Transfer Pricing for Developing Countries*, Second edition (United Nations, 2017) p558.

principle “does not work in most cases.”⁴⁸ This is not merely a matter of administrative simplification: Chinese officials conclude in the 2017 UN manual that there remains a broader question of “how to divide the pie between countries that are the location of economic activity and value creation.”⁴⁹

The centrepiece of China’s answer to this question is the concept of location specific advantages (LSA).⁵⁰ Imagine an MNC that relocates a key aspect of its manufacturing operations from a high cost location (e.g. the United States) to a lower-cost jurisdiction (e.g. China). The manufacturing activity in China generates a ‘routine’ profit, but the MNC may also generate substantial additional profits as a result of the arbitrage. OECD rules generally allow MNCs to attribute these additional profits away from their local operating companies and towards other areas of the firm, in particular its home country or a tax haven intermediary, commonly through payments for the use of intangible assets. The host country subsidiary, by contrast, is only assigned a limited profit margin, consistent with being a simple contract manufacturer. As described by Li and Ji: “The default position is that benefits from location savings are allocated away from the local subsidiary.”⁵¹ A Chinese government document argues this point as follows:

For a long time, in their competition with developing countries for more tax resources (tax base), developed countries have obtained most of the benefits generated by MNEs by relying on their dominant position in formulating the rules and superiority in technology and intangible property, while developing countries have obtained a very small share of the profits even though they

⁴⁸ “OECD transfer pricing consultation addresses special measures, related party contracts,” *MNE Tax*, 24 March 2015 <http://mnetax.com/7712-7712>

⁴⁹ Wang et al, “China Country Practice,” p549.

⁵⁰ Jinyan Li and Stephen Ji, “Location-Specific Advantages: A Rising Disruptive Factor in Transfer Pricing,” *Bulletin for International Taxation* 2017, no. May (2017): 259–71; Peng, “A Rethink of Location-Specific Advantages”.

⁵¹ *ibid*

have paid a price [for such profits] through providing huge market, cheap labour, using energy resources and damaging the environment.⁵²

The Chinese contention – embedded in the LSA concept – is that a portion of the ‘super profits’ that arise by virtue of operating in China should accrue, for tax purposes, to the Chinese subsidiary. As the Baker Mackenzie article cited earlier explained to its audience of tax practitioners:

Most multinationals do not realize that their strategy of allocating “routine profits” to China is under severe attack. To quote a Chinese tax director who has negotiated extensively with the Chinese tax authorities, “[i]t became clear that the State Administration of Taxation believes China has unique factors, including location savings and market premiums, that are not addressed by the OECD Transfer Pricing Guidelines [...]”⁵³

The SAT position is that China offers advantages not available anywhere else, which means firms operating in China are more profitable than comparable firms elsewhere. This might include a large, skilled labour force, high quality infrastructure, unique expertise, agglomeration benefits, and a large, relatively untapped consumer market. Table 2 gives six types of LSAs in an example given by China in the UN transfer pricing manual, in an entry that notes how: “The automotive industry is a good example where there are many LSAs that have led to extraordinarily high profits that are rightly earned by Chinese taxpayers.”⁵⁴ Here one can roughly distinguish two types of LSAs: ‘location savings’ which result from more efficient and lower cost production in a particular

⁵² Jiangsu Provincial Office of SAT, *Administration Plan for International Taxation Compliance in 2014-2015*. Quoted in Jinyan Li, “China and BEPS: From Norm-Taker to Norm-Shaker,” *Bulletin for International Taxation* 2015, no. June/July (2015): 355–70, p359.

⁵³ Yuan, Liu & DeSouza, “Changing Transfer Pricing Landscape”

⁵⁴ Wang et al, “China Country Practice,” p569.

location, and more controversial ‘market premiums’ which reflect access to a uniquely valuable local market. A simple example of a location saving would be the lower cost to manufacture a given unit of a product because of lower wages and higher productivity in China than in its competitors. At its simplest, a market premium would result if, for example, Chinese consumers were willing to pay more for a product than those in other countries.

Table 2: Examples of location specific advantages obtained by MNCs manufacturing automobiles in China

Location savings	Importing parts and assembling them domestically incurs lower duty rates than those levied on competing imported vehicles.
	There is a large supply of high quality, low cost parts made locally.
Market premiums	Foreign firms are obliged to supply technology to the local manufacturing subsidiary at lower prices to access the Chinese market, increasing the latter’s profitability.
	Chinese consumers have a “general preference for foreign brands and imported products” that mean MNCs can charge higher prices.
	The large consumer market creates “huge, inelastic demand for automotive vehicles in China.”
	There are capacity constraints on the supply of domestically assembled automotive vehicles, reducing competition.

Source: UN transfer pricing manual/Peng (2017)

China’s implementation of LSAs – both location savings and market premia – increases the share of MNCs’ profits that should be assigned to their Chinese subsidiaries to be taxed, but in doing so it violates the ALP. First, China regards LSAs as a way of internalising value-adding characteristics of the local market within a firm’s profits. Some of the items in Table 2 are direct or indirect government subsidies, while others are demand and supply characteristics of local markets. All of them create opportunities for foreign investors to realise additional profits beyond what they might make in other

markets. According to Tizhong Liao, Director General of International Taxation of the SAT:

Value is created by capital, by labor, by intangibles, but all of this happens in the market. The market has comparative advantage. The market has specific characteristics, which differ from one country to another, which explains why some companies lose money in their own market but once they move to China make a huge amount of money.⁵⁵

The emphasis on intrinsic properties of the market here points to a key difference in China's interpretation of LSAs, in comparison to the orthodox OECD position. The OECD, as articulated by Robert Stack, the lead US representative to the BEPS process, is that "the mere presence of a market is not an asset of the taxpayer to which profits are typically allocated under the guidelines."⁵⁶ This is because, while a market may offer certain advantages of the nature described by China, firms need to capture these advantages as location-specific *rents* if they are to be relevant to an assessment of the firm's profitability. OECD rules presume that this does not take place, and that the LSAs lead instead to lower consumer prices or more profits for independent contractors. Central to the conceptual challenge presented by China's use of LSAs is the presumption that foreign investors come to China in search of LSAs, *and* successfully capture them as rents.

Indicative of these tensions, the Indian tax authority has sought to implement a similar approach, but has stumbled at this conceptual hurdle, with Indian courts rejecting the use of LSAs by the Indian tax authority unless it can demonstrate that the taxpayer has actually captured resultant rents.⁵⁷ The legal culture and institutions of tax administration

⁵⁵ Quoted in Melnicoe, "Liao: International Tax Rules Must Adapt to China's Rise."

⁵⁶ "Conversations: Jeffrey Owens and Bob Stack"

⁵⁷ Li and Ji, "Location-Specific Advantages" p264.

in China mean that the SAT does not face a similar threat of being overruled by courts, and, indeed, there is no public record of any disputes over the use of LSAs.⁵⁸ The SAT has thus not needed to draw the same distinction between local specific advantages and rents as its Indian counterpart, enabling it to capture a greater share of taxable profits.

In addition to the general existence of LSAs, China argues that the share of profits assigned to Chinese firms should likely increase over time as local subsidiaries become less dependent on foreign intellectual property, and begin to contribute greater innovation and local expertise. An example given by Chinese officials is the *Head & Shoulders* brand name, owned by US firm Procter & Gamble, which has been given a Chinese name that translates as “fly in my hair in the windy sea.”⁵⁹ China argues that local subsidiaries should be more effectively rewarded for the value created by ‘materializing’ foreign intellectual property in this way, in combination with the power of the local market, as Liao explains:

You may have a trademark in your jurisdiction, and that trademark has its original market share. But it has a new market share once it's introduced into China. The market share grows hugely, dramatically. Because of the geographical coverage, because of the demographic coverage, because of the growth and increase of the effectiveness of demand of this population, the growth of demand leads to growth of value. We believe the increase of the value because of the increase of the market share should be remunerated.⁶⁰

⁵⁸ Ni, Y. (2017). Tax Treaty Disputes in China. In E. Baistrocchi (Ed.), *A Global Analysis of Tax Treaty Disputes* (pp. 761-816). Cambridge: Cambridge University Press.

⁵⁹ Kevin A Bell, “Chinese Tax Auditors Remunerating Local Affiliates For Location Savings—‘Like It or Not,’ SAT Official Says,” *Transfer Pricing Report* 21 (2013): 1079.

⁶⁰ Quoted in Melnicoe, “Liao: International Tax Rules Must Adapt to China’s Rise,”

A third and even more contentious element of China's use of LSAs elevates the debate from a relatively technical level to a much larger conceptual challenge to the ALP itself. OECD rules have historically proposed that the profitability of an MNC subsidiary should be assessed in isolation, in comparison to a locally-owned independent enterprise. By contrast, LSAs imply that "you should take the group as a whole."⁶¹ As the Chinese contribution to the UN transfer pricing manual in 2017 states:

With more and more companies poised to conduct business as groups, economic activities are more and more likely to take place in the inner circle of MNE groups. It is nearly impossible to take out one piece of a value chain of an MNE group and try to match it to comparable transactions/companies.⁶²

It is this collapsing of the legal fiction that an MNC can be modelled as a group of separate entities trading at arm's length that enables China to capture a share of the group's 'super-profits' within its tax base. Chinese subsidiaries are, in their view, entitled to a share of group profits consistent with their overall contribution to value creation of the MNC group.

The importance of the Chinese position is reflected in public comments made by Robert Stack, the United States' BEPS representative:

The OECD countries all ascribe [sic] to the arm's-length standard and to what they call the basic OECD principles. Other countries have not signed on to the full implementation of the arm's-length standard and the OECD guidelines, even countries that are in the G-20. And the reason this is very important is the question of market premium and intangibles that relate to

⁶¹ Liao, quoted in Kevin A Bell, "Chinese Tax Auditors Remunerating Local Affiliates For Location Savings—'Like It or Not.'"

⁶² Wang et al, "China Country Practice," p566

markets and things like location-specific advantages that are specifically talked about in the OECD guidelines....[China should] not pick a rifle-shot issue that favors a large-market country and try to gerrymander the debate from that narrow issue.⁶³

While these comments are packaged in technical language, such public comments condemning the Chinese approach, by a senior official in the negotiations, are suggestive of the depth – and significance – of the Chinese challenge.

Yet despite significant reservations, the OECD has agreed to meet China halfway. During the BEPS discussions, OECD member states quietly accepted that location savings can be taken into account when assessing the profits made by local subsidiaries.⁶⁴ In turn, China has sought to align its practical application of LSAs closer to the logic of the OECD guidelines.⁶⁵ China's application of LSAs remains more expansive than what OECD members would prefer, or are comfortable codifying in OECD guidelines. But these compromises have created adequate space for China to continue with current practices, while avoiding any open conflict over broader OECD rules.

There has, by contrast, been no explicit compromise over the 'market premiums' component of LSAs. For the reasons outlined above, China's position here is even more at odds with the OECD-led international consensus. That position is expressed clearly in a Chinese government document:

China has a huge population and a fast-growing middle class that form a great market capacity and huge consumer groups. This factor is unique in the world and inimitable by other small and medium-sized developing countries. Those

⁶³ "Conversations: Jeffrey Owens and Robert Stack," *Tax Analysts*, accessed May 16, 2018

⁶⁴ Peng, "A Rethink of Location-Specific Advantages", p490

⁶⁵ *Ibid*, p497.

MNCs which occupy major market shares in China should fully consider and quantify the contribution of this factor.⁶⁶

China's increasing focus on market premiums – and OECD resistance to them – appears linked to China's planned transition from “world factory to world market”, which will make market premiums increasingly important in tax terms. And for the time being China appears to be moving ahead with the inclusion of market premiums in its calculation of LSAs, despite OECD objections.

Beyond Conflict versus Cooperation

Existing literature on China's role in global economic governance has tended, explicitly or implicitly, to present a dichotomy: would China seek to cooperate with existing, western-led, global institutions, or to challenge or undermine them? Most of the literature has pointed toward relatively cooperative strategies, integrating into existing institutions while pushing for only modest “balancing” reforms.⁶⁷ This has been mirrored in the rhetoric of OECD governments that have sought to “socialize” China into existing frameworks of global economic governance, in hopes of forestalling more aggressive Chinese efforts to exploit their growing economic power on the global stage.⁶⁸

However, recent debates over international tax rules defy easy characterization. On one hand, China has been a vocal supporter of the OECD BEPS process, contributing to broad global endorsement of the BEPS recommendations. On the other hand, it has

⁶⁶ Jiangsu Provincial Office of SAT, *Administration Plan for International Taxation Compliance in 2014-2015*.

⁶⁷ for example, Hongying Wang and Erik French, “China in Global Economic Governance,” *Asian Policy Review*, Vol. 9 (2014): 254-271

⁶⁸ Johnston, Iain Alastair. *Social States: China in International Institutions, 1980-2000*. (Princeton University Press, 2007)

quietly but forcefully advanced significant challenges to the status quo. In simultaneously acting as a vocal supporter of existing institutions and seeking to carve out special treatments and benefits, China's engagement increasingly appears to mirror the strategies historically adopted by the United States.⁶⁹ In what follows we identify three overlapping ways in which the story of LSAs sheds light on China's emerging global ambition: it points toward a more assertive Chinese stance within multilateral negotiations than has generally been portrayed in existing literature; it highlights China's conceptualisation of its interests as unique, diverging from traditional alliances; and it speaks to the extent to which China's growing market power is enhancing its global power, and ability to force others to accommodate its preferences.

Consider first the subtle assertiveness on display through China's advocacy for LSAs. While China has expressed substantial misgivings about OECD rules, its official stance has been public and supportive. During China's G20 leadership in 2016 official communiqués and statements from the SAT repeatedly highlighted the importance of the BEPS project.⁷⁰ Meanwhile, China moved quickly and prominently to implement key BEPS recommendations.⁷¹ In official OECD forums China has muted its critiques, while participating actively in BEPS consultations – sometimes in leadership roles.⁷² China has

⁶⁹ Radaelli, "Game Theory and Institutional Entrepreneurship"; Michael Durst and Robert E Culbertson, 'Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Today', *Tax Law Review*, 57 (2003), 37–136

⁷⁰ See, for example, State Administration of Taxation, *Reaching Consensus on International Taxation Cooperation Becomes Highlight of G20 Finance Ministers and Central Bank Governors Meeting*, 2 March 2016. This assessment is shared by Avi-Yonah and Xu, 2017.

⁷¹ See, for example, Tony Dong *et al*, "Transfer pricing in China: overview", *Thomson Reuters Practical Law*, 1 May 2017.

⁷² China had been a regular observer at the OECD's Committee on Fiscal Affairs for some time before the BEPS process was launched, and became an Associate member with equal voting rights as part of the BEPS process. Chinese officials also hold senior positions on several subsidiary committees, including Working Party 6, which deals with transfer pricing issues.

worked with the OECD to establish an OECD training center in China, offering a visible signal of close engagement. A senior OECD official described that the “most important unifying factor is they are very engaged” – “they turn up to all of the meetings, of which there are 100s” and “they seem generally not to fight.”⁷³ This stands in contrast to other large emerging markets. Brazil, for example, employs simplified transfer pricing rules that make it the only major economy not to follow the OECD guidelines, and pushed for the UN transfer pricing manual to become a forum for emerging markets to articulate contrasting views.⁷⁴ Likewise, India has most actively pushed for an intergovernmental UN tax body and recently contributed funds to the UN’s tax work – the only state to have done so.

Yet while China has offered surprising outward support for historically western-led institutions, it has simultaneously used the cover offered by complex technical debates to pursue very significant challenges to existing rules. At a minimum, China’s push for the use of LSAs domestically – and for their partial inclusion in OECD guidelines – has been a relatively aggressive effort to secure a larger share of the global tax pie, with rules tailored to China’s purportedly unique characteristics. Seen more expansively, the Chinese position poses more profound challenge to the foundations of the ALP, and thus to OECD orthodoxy, cutting near the heart of a key feature of global economic rules that have prevailed for almost a century. Against this background, China’s engagement with the OECD is best understood not as cooperative or conflictual, but as a strategic mix of both. Rather than seeking to tear down key pillars of the existing institutional infrastructure, it has instead obtained a seat at the table in the OECD’s technical bodies, alongside political influence through the G20. This so-called “G20 institutional transition”⁷⁵ gives China significant continuity, the benefit of the OECD’s technical

⁷³ Phone interview with senior OECD official, November 2017

⁷⁴ This can be seen in the early drafts of the Transfer Pricing manual

⁷⁵ Zhu, Jiejun, “G20 Institutional Transition and Global Tax Governance,” *The Pacific Review*, vol. 29 (2016): 465-471.

expertise, and a more powerful voice as a member of a club of 20 than would be the case at the more inclusive UN. In this view, China's flirtations with the United Nations appear to be a combination of good politics with other developing countries, and leverage in negotiating with the OECD.⁷⁶

There is a temptation to equate these developments with the “dual track” strategies adopted in the realms of trade and development aid: cooperating with existing institutions, while challenging the status quo through parallel initiatives outside of those institutions. However, the case of international taxation is different. Because the coordination problem of international tax rules requires a universal set of global rules, China has had to develop strategies to achieve both its short and long term economic goals simultaneously *within* a single set of global negotiations and rules, while confronting explicit resistance by the entire group of OECD states. In this context the Chinese focus on LSAs appears ingenious. LSAs pose a potentially profound challenge to OECD orthodoxy, but China has found ways to present them as a simple extension of – and improvement on – OECD guidelines.⁷⁷ This has allowed the OECD to make relatively modest changes to its rules, which have provided enough cover for China to pursue a more far-reaching implementation of LSAs domestically without coming into direct conflict with the OECD. In this respect Brazil offers a telling contrast: the OECD has consistently rejected including Brazil's simplified approach to taxing MNCs in the OECD guidelines, while informing Brazil that changes to its transfer pricing rules would be a pre-condition for joining the OECD.⁷⁸

⁷⁶ One OECD official described China's statements about the UN Tax Committee as “pure politics” (Phone interview, November 2017)

⁷⁷ Li and Ji, “Location-Specific Advantages”

⁷⁸ “Launch of the Transfer Pricing Work Program,” OECD, February 28, 2018, <http://www.oecd.org/ctp/transfer-pricing/launch-of-transfer-pricing-work-programme-brazil-2018.htm>

Critically, these compromises appear aimed not at generating *general* benefits for all developing countries, but at carving out *special* benefits for China. Rhetorically, China has presented itself as a champion of developing country concerns. A SAT webpage approvingly quotes a Chinese academic observing that: “The formulation of the global tax rules has long been dominated by developed countries, with appeals of developing countries not taken into full consideration.”⁷⁹ It goes on to document concerns common to a wide range of developing countries. Yet China’s practical commitment to representing developing country interests appears increasingly uncertain, despite the provision of gradually increasing technical assistance. Its advocacy of LSAs appears likely to carry benefits to China, which will come at the expense of developing, as well as OECD, countries, given the official view that China’s market premium is “unique in the world and inimitable by other small and medium-sized developing countries.”⁸⁰ This appears equally reflected elsewhere: China has pursued a similarly self-interested approach to bilateral tax treaties, while insiders claim that China has likewise abandoned support in recent years for proposals designed to strengthen the ability of developing countries to tax technical service fees and digital firms. Ultimately, focusing on LSAs strengthens China’s hand in trying to tax OECD MNCs, without risking the imposition of additional taxation on Chinese MNCs operating in developing countries.

Recent writing on so-called ‘Chinese Exceptionalism’ has drawn attention to China’s rhetorical focus on being a “new kind of global power”, emphasizing peace and accommodation.⁸¹ However, that literature has also highlighted the tension between

⁷⁹ “Multi-Pronged Measures Reflective of Responsible Tax Authorities in China— Overview of Taxes Supporting the Belt and Road Initiative,” State Administration of Taxation of The People’s Republic of China, May 11, 2017, <http://www.chinatax.gov.cn/eng/n2367726/c2694305/content.html>.

⁸⁰ Jiangsu Provincial Office of SAT, *Administration Plan for International Taxation Compliance in 2014-2015*

⁸¹ Feng Zhang, “The Rise of Chinese Exceptionalism in International Relations,” *European Journal of International Relations* 19, no. 2 (2013): 319

official ideologies stressing cooperation and China's desire to reclaim its former status as a great power.⁸² The experience of international tax reform points toward the importance of the latter in contributing to an emerging form of exceptionalism. In this case at least, and mirroring the United States before it, China's purportedly exceptional characteristics have acted as justification for using its market power to press for unique advantages. More broadly, China has been strategically Janus-faced: presenting a more cooperative public face, while pursuing more specific and narrow benefits in parallel. In retrospect it is perhaps unsurprising that China would exploit its growing market power to pursue such advantages, while shifting its focus away from meaningful solidarity with other developing countries. Yet both developments stand in contrast to earlier trends in China's engagement in multilateral fora, and suggest the rapid evolution of China's priorities and capabilities in relation to global economic governance.

Conclusion: What Comes Next?

The recent reform of international tax rules offers a fresh look at Chinese engagement with global economic governance, and challenges dominant narratives. Far from a cautious participant, China has been highly visible in recent reform efforts, has embraced and implemented significant new global rules and has diplomatically but forcefully secured a profound, if subtle, change to those rules. It has, in turn, diverged still further from global rules in its domestic implementation by exploiting the margins available to a powerful state when implementing global soft law. Indeed, the very same location specific advantages that China seeks to tax offer it significant market power and negotiating leverage, allowing it to break from the OECD consensus without jeopardising the prospect of inward investment. While China's approach to international tax rules presents parallels to the literature on "dual track" strategies, what we describe is nonetheless quite different, as China has pursued its objectives not through parallel

⁸² Ibid, p.307-328

institutions, but through direct negotiation with powerful OECD states. In turn, this account moves beyond the common debate over whether Chinese strategies will be cooperative or conflictual: so far they have been both, calibrated to pragmatically maximize Chinese benefits.

In adopting these positions and strategies China increasingly resembles the global superpower that came before it: the United States. To be sure, because China is emerging alongside the already established OECD powers it has moved diplomatically, seeking to present its approach to international taxation as an extension of OECD rules rather than a repudiation of them. But it seems clear to observers – and is acknowledged by individuals with close knowledge of the negotiations – that the OECD ultimately accepted a compromise with China on LSAs because China had significant leverage, while compromise was viewed as an acceptable price to pay to secure Chinese engagement and cooperation.⁸³ The same logic has applied to the United States in tax cooperation and across a host of domains of global economic governance over several decades. In that sense China’s strategy is in some ways unremarkable: it is more clearly now doing what powerful states have always done. It appears surprising primarily in contrast to hopeful narratives about the possibility that China might more actively advocate on behalf of developing countries, and more skeptical narratives that have cast doubt on China’s capacity to craft a coherent and unified global strategy.⁸⁴

What remains unclear is what might come next, both for international tax rules and for global economic governance more broadly. The BEPS process only ever offered relatively limited potential for change at the global level, as it was “not designed to

⁸³ Interview with national OECD representative to the BEPS process, New York, February 2018

⁸⁴ Illustratively, one senior official in an international organization, when discussing the Janus-faced character of Chinese actions at the global level, proposed that a plausible explanation is that “it might be intergovernmental chaos”, or could be driven by local political agendas. Phone interview, November 2017.

rethink the arm's length principle [in order] to assign more value to productive activities and markets in both developing countries and developed countries.”⁸⁵ We suggest that the future may move in two broad directions.

First, the strategies described here may offer a relatively clear view of China's emerging approach. China will seek to exploit its market power to secure specific advantages, and increase its visibility as a global power, but while minimizing conflict and avoiding undermining core pillars of the existing institutional order. In this view China's engagement is increasingly coherent and assertive, but fundamentally pragmatic and incrementalist. Recognizing that its long-term interests are likely to increasingly align with those of the old powers, a combination of incremental changes at global level and selective unilateralism offers greater flexibility to adapt as China's place in the global economy evolves.

Second, by design or accident the Chinese challenge to the ALP may prove to be the first step in a process of more dramatic reform, which will place increasing stress on existing institutions and rules. To accept the premise of LSAs is to concede that the purportedly “neutral” ALP promoted by the OECD in fact has important distributional implications, biasing the system against developing countries. Such a discussion was explicitly taken off the table during the BEPS negotiations.⁸⁶ Yet by opening cracks in the existing system, LSAs may lead other countries – perhaps led by other large emerging markets – to seek their own accommodations, thus placing increasing strain on the multilateral foundations of the international tax system. While far from assured, the potential for initially small challenges to existing orthodoxy to create a snowball effect of expanding challenges can be seen in other aspects of recent international debates. The UN Transfer Pricing Manual, in which China initially presented its critique of the ALP, had initially only intended to feature a brief discussion of the Brazilian approach to transfer pricing

⁸⁵ Li, “China and BEPS: From Norm-Taker to Norm-Shaker,” p370.

⁸⁶ OECD, “Action Plan on Base Erosion and Profit Shifting”

enforcement. However, the inclusion of one alternative approach prompted China, India and others to seek chapters detailing their own unique national experiences. Similarly, recent years have seen OECD led efforts to develop multilateral guidelines for taxing the digital economy be increasingly challenged by pragmatic, but unilateral, national legislation, with each new national law enhancing incentives for other states to adopt their own unique solutions, but at risk of undermining the multilateral framework. It remains to be seen whether China's successful challenge to the ALP will similarly prompt subsequent challenges from elsewhere.