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Economic Prospects in the Eurasian Region and BEPS

by

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Editor's Note

This paper is based on Dr. Jeffrey Owens' opening remarks at ITIC's 10th annual Eurasia Fiscal Policy Seminar, jointly organized with the Institute for Austrian and International Tax Law, and hosted on the campus of Vienna University of Economics and Business on 8-10 July 2014.

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I would like to set the scene for our discussion by giving a quick overview of where the global economy stands.

It has been more than half a decade since the global financial crisis burst upon us. Much has been achieved since then and new financial rules have been put in place. But there is still much to be done. "Too big to fail" institutions are still a problem. EU financial integration is incomplete. The Euro crisis is waiting to erupt again.

But it is probably fair to say that the global economy is strengthening, although the outlook is far from predictable.

So, let us take a quick economic tour around the globe, starting with the US.

Despite a fairly weak start to the year in GDP terms, largely as a result of the extreme weather, the US is gaining strength. The current environment is very favourable for FDI. Why? Low energy prices, low inflation, interest rates and underlying entrepreneurial flair (Google, Facebook…). There are a lot of positive factors. The job market is starting to pick up, although not strongly, and wage growth is improving.

In the Eurozone, it is a less rosy picture. The big risks here are deflation and divergence. Some core countries like France, Italy, the Netherlands and Belgium are growing very slowly. Peripheral countries like Spain, Ireland and Portugal, that implemented reforms and are no longer in the bail-out stage, are benefitting as the world economy picks up steam.

Japan remains very mixed. Monetary and fiscal policy is very much the centre of attention, as is tax reform. Consumer activity has shown signs of picking up, but there is still a question mark over whether the third arrow of Abenomics (structural reforms) will succeed.

Turning to the emerging markets and the CIS region, things have been quite subdued. Many countries are still growing faster than the developed markets, but at a slower rate than in the recent past, and the potential for more volatility is high.

In China, there has been a lot of speculation about a hard landing. The Chinese government has reaffirmed its 7.5% growth target for 2014, but it is clear that the process of rebalancing the economy – moving from an investment and export-led economy to a more consumer-lead economy – is proving difficult to achieve.

That being said, China remains a tremendous market opportunity. The number of Chinese households with annual incomes of over $35,000 is set to increase to around 80 million over the coming decade. In June, Alibaba´s public offering would value the company at around $168 billion, bigger than 95% of the Standard & Poor´s 500 Index – and the most valuable Internet company after Google. But we have to be realistic: it will take 3 generations for China to reach the US GDP per capita.

The recent gas deal between China & Russia will help diversify China´s energy reliance (and reduce costs).

Russia is facing lower growth and continues to be over-dependent on energy. Other economies in the CIS region can be divided into those which are resource rich (Kazakhstan, Azerbaijan) and those which are not (Armenia, Georgia). The resource rich countries have reasonable prospects, so far as energy prices hold. And other countries, where the growth prospects are more subdued – as the EBRD recently put it: a number of countries in the Eurasian region are "stuck in transition".

There is a marked slow-down in reforms virtually throughout the region. The financial crisis did not help and citizens are turning against markets, even though well-functioning, well-governed, transparent and inclusive markets are the long-term solution.

Productivity growth will decline in the following decade and this implies that convergence with living standards in Western Europe would stall in some CIS countries.

Only the countries of Central Europe and the Baltic states would reach or exceed 60% of the EU15 average per capita income in the next 20 years. Most countries in the transition region would remain far below this threshold. This is a depressing prospect.

These countries need to re-energise transition by:

- Building sound institutions (including tax administrations), addressing the issue of corruption and lack of good governance.
- The whole region needs to promote economic integration. Integration has been at the heart of the transition project, helping to raise levels of growth and improve standards. We need to do more on this score.
- Countries in the region need to work together to address common global challenges such as climate change, water scarcity, inequality and food security.
- The current fiscal health of transition countries varies substantially. But most transition countries have public debt levels below 60% of GDP and deficits below 5% of GDP – both favourable figures relative to many Eurozone countries – though rather high when compared to levels markets many consider healthy for emerging economies.

So let me now turn my attention to tax.

The themes and potential outcomes of the OECD´s Base Erosion and Profit Shifting project will dominate the international tax debate.

Countries are not waiting for the outcomes from the BEPS project: there is a BEPS empowerment with tax administrations using the political support to put in measures they have long sought: limitations on the tax treatment of losses, tighter transfer pricing and thin capitalization rules, changes to withholding tax regimes, tougher CFC rules and limitations on the deductibility of interest and business expenses. More recently, we have seen a rapidly growing focus on restricting relief on payments made to "low tax" jurisdictions.

Countries are also increasing tax enforcement to protect and enhance the revenue base by improving disclosure and transparency, focusing on business "substance" within transactions and – more and more often – scrutinizing transactions with tax havens (note recent Russian measures on "de-offshoring" – a new word in the English language!)

When we met last year in Paris, we had Mr. Pascal Saint-Amans, Director for the OECD's Centre for Tax Policy and Administration, unveil the OECD´s 15 point BEPS Action Plan. We knew few details, but we did know there would be common areas of focus such as coherence, substance and transparency. We also knew the timetable ("crazy" as Mr. Saint-Amans has said). Seven for September 2014 and eight for September 2015.

What can we expect to be submitted to G20 Finance Ministers' meeting in September?

- A grand vision of a completely new way to report on and tax the digital economy. (All successful MNEs are now digital companies).
- Proposals for extensive country-by-country reporting and a master file for transfer pricing become reality.
- Procedures to curb treaty abuse by having a general anti-abuse rule in the model tax treaty, as well as a limitation on benefits provision.
- Recommendations on hybrid mismatch requiring a multinational corporation to document the tax treatments of each cross border intercompany transaction in two or more jurisdictions.

After September, we will be coming to the most difficult stage of the BEPS project. That is when the countries will seek to interpret the recommendations of the OECD so far and the compromise texts that will likely emerge. And some governments may want to wait for all recommendations to be made before committing to tax changes.

All of this action will generate uncertainty for business and governments in the Eurasian Region. Yet, when I talk to Kazakh, Russian or Ukrainian companies, few are aware of how BEPS is going to change the international tax environment within which they operate.

I hope that ITIC can play a useful awareness raising role.