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# The Economic Benefits of the Use of Guanxi and Business Networks in a Jurisdiction with Strong Formal Institutions: Minimisation of Taxation

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## ***Abstract***

*Why rely on informal institutions when conducting business? Because it leads to a greater economic return*

The current academic status quo on the use of guanxi and business networks by Chinese entrepreneurs in both China, South East Asia and beyond is that it is a response to the weak formal institutional environment<sup>1</sup>. It is argued that weak institutional environments create an economic rationale for the use of guanxi and business networks. From this base, it is further asserted that the use of guanxi and business networks will reduce and disappear with the strengthening of formal institutions in China and other jurisdictions. This paper will challenge this latter assertion by arguing that there are strong economic benefits to those that are able to operate through guanxi and business networks in a jurisdiction with strong formal institutions. The primary benefit that will be examined is the reduction or elimination of business taxation which is a very significant issue in most jurisdictions with strong institutional environments. This paper will demonstrate how guanxi and business



The above assertions are supported by demonstrating that Chinese entrepreneurs operating in both transformation China and many parts of South-East Asia have had to contend with formal institutional environments that are very poorly developed and weak, aggressively negative towards them or both<sup>7</sup>.

Developed formal institutions for doing business were largely non-existent in pre-colonial South-East Asia when Chinese business first took root in the region<sup>8</sup>. The colonial period bore witness to formal institutions largely geared towards European colonial interests while the post-colonial period has seen the slow and incomplete development of formal institutions in many of the newly independent states. In China, formal institutions for private economic activity were obliterated by communism and have only begun to reemerge since 1979. They still remain weak<sup>9</sup>.

Formal institutional environments that are or have been negative towards Chinese entrepreneurs have also been common in the region. The source of this negativity being that many states in the region have been anti-entrepreneur, anti-Chinese or both. At many points in history, the imperial Chinese state has been at the very least unsupportive of entrepreneurial activity. The origins of this attitude being a belief in a state order from peasants to emperor that does not value entrepreneurs or merchants<sup>10</sup>. The period of staunch communism in China was clearly against entrepreneurs and lingering socialist values have ensured that entrepreneurs during much of the transition period have tended to be discrete about their affairs.

In certain other parts of the region similar state values based upon anti-merchant traditions and communist experience have had a similar effect in many eras. However, the situation has been made significantly more severe by anti-Chinese sentiment in both colonial and post-colonial states in the region. Fear and resentment of Chinese influence and potential economic domination in most post-colonial states in South-East Asia have led to both direct and indirect measures to suppress Chinese economic activities or prevent them<sup>11</sup>.

Colonial states on the other hand simply attempted to ensure that the European colonists were the primary beneficiaries of all economic activities. These situations have therefore been anything but strong formal institutional environments in which Chinese entrepreneurs could operate. A particularly difficult situation when many of the Chinese pursuing business activities have been doing so due to their exclusion from their environment. Business ve any of

of economic success<sup>12</sup>. In this case, however, the lack of opportunity has been caused by the inability of these people to sustain themselves through primary production rather than formal exclusion.

Trade and business activity involve shifts of wealth between individuals and groups. It is therefore a general prerequisite for the existence of such activities at any meaningful scale that institutions are available to protect rights to wealth and reinforce adjustments to them. At the very least formalized property rights should exist. Thus in a developed capitalist state property rights are upheld by the state and courts while trade is reinforced by contracts and the legal institutions that support these. Commerce is therefore supported by formal state institutions.

and western countries, it may be argued that Chinese entrepreneurs base their decisions on market factors due to the strong institutional support<sup>16</sup>. Finally, reinforcing the argument in the other direction, there are studies that show that certain non-Chinese groups also make use of similar informal institutions when faced with a lack of formal institutional support<sup>17</sup>.

Based on the above, it is becoming increasingly common to assert that Chinese business modalities that make use of networks and guanxi are not the product of Chinese culturew

formal institutional environments due to the lack of institutional support. This fact being something which is too often ignored by those that seek to show that Chinese culture is irrelevant by demonstrating that some other group uses similar informal institutions to overcome problematic formal institutions.

In addition to income tax, Australia's goods and services tax (GST) will be imposed at a rate of 10% on all sales of goods and services, an amount that can be highly significant in relation to net profit. It would constitute 30% of net profit if net profit was 30% of sales. While GST is arguably a cost on consumers and not business, this is not entirely the case for all businesses and there is certainly a significant commercial advantage to those that can reduce their GST burden. If the GST is evaded the business can either reduce the cost of their product thereby increasing sales or keep the evaded GST and increase the return on their activities.

The rates of taxation imposed in countries such as Australia mean that there is indisputably significant value attached to the reduction of taxation. This will be the case whether this reduction is achieved through planning, avoidance or evasion. For example, a restaurant owner that sells a meal for \$22 may only make \$5.35 after costs (say \$10), income tax (\$4.65) and GST (\$2). This amounts to 24.3% of sales value. If this person were to successfully evade taxation by not declaring the sale for tax purposes the return becomes \$12 or 54.5%. This amounts to a more than doubling of the return on the activity.

The value associated with reducing tax burdens through more legitimate means in Australia is further attested to by the significance of the tax profession and the value of the tax planning industry. The potential cost of taxation is of such significance that a tax reduction technique, legitimate or otherwise, can determine the actual viability of a business venture or even an industry. It is indisputable that the ability to successfully reduce your tax burden is highly desirable and valuable.

#### **REDUCING BUSINESS TAX BURDENS THROUGH ARBITRAGE**

High general-rate income and other taxes inevitably allow for a lower tax burden in the case of certain taxpayers and situations. They may also impose a higher burden or in some manner differential tax treatment on certain other taxpayers or situations. There are numerous reasons for this including equity, social policy, simplicity, economic policy, enforceability and jurisdictional limitation. Thus taxpayers on lower incomes may attract a lower rate of taxation due to their inability to reasonably pay the general rates or to encourage their businesses to grow. On the other hand undesirable activities may attract heavier tax burdens while those that are desirable may attract a lighter burden. Finally, it may be impossible to collect a high rate of tax in relation to certain situations and the Government may then impose an enforceable lower amount of tax.

All the above issues inevitably result in a tax where highly differential tax burdens will arise depending on characterisation of taxpayer, business, both of these or some other factor. This in turn results in significant arbitrage possibilities as financial benefit accrues to those that can alter the relevant factors. These financial benefits are very valuable due to the high general rate of taxation imposed and the fact that one of the aforementioned policies may apply a nil tax rate or even a negative tax rate<sup>20</sup>. The exploitation of these arbitrage opportunities is at the heart of tax planning and tax avoidance.

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<sup>20</sup> This may be the case when a welfare payment is made to those on low incomes.



### **NON-MARKET BASED TRANSACTIONS AND ARBITRAGE**

Non-market based transactions are integral to tax arbitrage through planning and avoidance. They can be used to shift income from one taxpayer to another who is granted differential treatment. They can also be used to transfer value from one situation to another. Finally, non-market based transactions can be used to alter the actual nature of a taxpayer or situation.

Many well known tax arbitrage strategies ranging from income splitting by professionals and small business to international transfer pricing by multinationals rest upon essentially simple non-market based transactions that shift income from one taxpayer to another. It may be a self-employed doctor paying a 'wage' to their spouse in the case of the former or the payment of royalties and management fees to offshore associates in the latter. In terms of altering the actual nature of a situation through non-market based transactions, an example may be inflating investment in research and development through an associate to qualify for preferential treatment.

### **EVASION OF TAXATION AND THE HIDING OF EVIDENCE**

Evasion of taxation differs somewhat from arbitrage through planning and avoidance. In the case of evasion the taxpayer may seek to simply hide a transaction or activity entirely in order that they do not pay tax in relation to it. This may be readily done by simply not declaring an amount of cash income. However, to be done successfully at a significant scale, the taxpayer will need to be able to hide outward signs of business activity and income accumula

focus on identifying tax evasion and collecting any available information that will allow the law to operate correctly.

**IDENTIFYING NON-MARKET TRANSACTIONS**

## WHO ARE ASSOCIATES?

In considering the link between associates and non-market transactions, it is instructive to consider which taxpayers are usually considered to be associates. Section 318 of the Australian *Income Tax Assessment Act* (1936) (ITAA 1936) contains the most extensive definition of associate used in Australian income tax law. It is used in a number of key areas along with other less extensive definitions for certain purposes<sup>21</sup>. It has been reproduced in Appendix A along with an extract from s995-1 (*Income Tax Assessment Act* 1997) that defines what a relative is. The definition of a relative is essential to the definition of an associate as a relative will be an associate. Relatives are also “related entities” being a term that is used in the stead of associate for some purposes<sup>22</sup>.

A review of taxpayers that are included as associates in the definition indicates that they fall into several broad categories:

- Individuals that are relatives (including spouses) are associated
- Entities that have a control connection based upon shareholdings and other legal factors are associated
- Those in a legal partnership relationship are associated
- Trusts and their beneficiaries are associated
- Companies that customarily act in accordance with the wishes of others are associates of the others

The success of legal and administrative measures that attempt to contain tax arbitrage through non-market transactions is brought about through the scrutiny and adjustment of interactions between associated taxpayers. Such scrutiny and adjustment is feasible as associated taxpayers are readily defined and identifiable as being relatives and entities with defined formal legal relationships that are recorded. The underpinning logic of this mechanism is that taxpayers will only engage in non-market transactions and arrangements with relatives or entities with the type of recorded formal relationship specified above.

#### **ASSOCIATES AND THE HIDING OF TRANSACTIONS, ASSETS AND ACTIVITIES**

As with arbitrage through planning and avoidance, the process of identifying wealth and signs of business activity in countering tax evasion needs to pay particular attention to the associates of the taxpayer being scrutinised. In addition associates need to be considered in the process of reconstructing income figures during the

The need for formal institutional support is the driving factor behind the creation and availability of most documents, registers, records, accounts and contracts that record business activity, transactions and assets. These records are however then available to tax administrators and constitute their primary source of information to work with. This is clearly an undesirable outcome for a would-be tax evader. Returning to the parent above, the recording of the loan may lead to income tax on interest and stamp duty on contracts. It would also highlight the activity of the child for which the money is being used.

There is therefore a clear benefit and rationale for dealing with associates and relying on informal institutions for protection. If you sell to associates you may not need to issue receipts, if you buy from associates you may not need contracts and invoices, if you use associates as sources of credit and equity, you may not need to produce detailed and accurate financial statements or record ownership through a corporate

defined or taxpayers with a specified formal relationship. Put another way it depends upon associates only being those close relatives and specified taxpayers.

The accuracy of this assumption in societies such as modern Australian society and other western societies where such rules of association have been developed seems reasonable. If any criticism were to be leveled at the definition of associate in the ITAA, it would be that it is overly harsh. This is because the assumption that dealings between relatives such as adult siblings or individuals and their uncles and aunts would be off-market or informal is just as often false as it is true. Even many parents and their adult children in modern Australia can be said to deal with one another at arm's length. However, the inclusion of relatives as defined is necessary as it is clear that in western societies such relatives may deal with one another informally and off market.

The ideal of individual independence is deeply rooted and strong in western society<sup>23</sup>. It is also growing stronger as witnessed by the growing propensity of even the closest familial relationships such as spouses to rely upon formal institutional specification of individual property rights rather than operate in a unitary fashion or trust informal institutions. This independence is reinforced by formal institutions and dependent on formal institutions. It in turn in itself reinforces these formal institutions. It leads to the belief that reality is that which is represented by formal institutions.



The question that arises from the above is whether persons that are likely to have the appropriate relationship with one another can be characterized in a way that allows the law to identify them. This is what is done in the current Australian law where close relatives (as defined) are included as associates. Referring to seminal work on Chinese society such as that done by Fei Xiaotong<sup>24</sup> as well as to some studies of 'patricorps' in South East Asia and beyond<sup>25</sup>, the impression is that membership of the patrilineage-extended family would be the appropriate characteristic.

#### **FAMILIES AND PATRILINEAGES**

Fei's work argues that economic activity is organized through the patrilineage in Chinese society and that relatives with the appropriate relationship will almost inevitably collude for mutual benefit. Very specific detail is often given on the nature and strength of the relationship within the family as well. For example married daughters would not be expected to have a strong collaborative relationship with their parents and brothers but sons would. If these assertions hold true for Chinese society, it means that it is possible to define associates in a manner more suited to Chinese society. The members of the patrilineage as defined by Fei would all be defined as associates creating a far wider net than that provided by the definition of relative in s995-1 of the ITAA.

The definition would also differ as arguably (for reasons just mentioned) married daughters, say, would not be appropriately branded associates. The strength of the informal bonds between patrilineage members as portrayed in Fei's work would merit a case for the patrilineage to constitute a tax unit let alone a group of associates.

#### **FLEXIBILITY AND STRENGTH IN RELATIONSHIPS**

Having seen a possible solution to defining associates in a Chinese society, a problem arises when further evidence on Chinese social connections is reviewed. That is that Fei's descriptions are not an accurate portrayal of Chinese social relationships at least in contemporary Chinese society. Arguably, they were not accurate in the past either. Rather, they represent an ideal for Chinese social relationships, a core of ideas which does underpin Chinese society but does not portray it accurately. Indeed, a deeper reading of Fei's work indicates his awareness of this<sup>26</sup>.

There is clear evidence that guanxi relationships or network membership in contemporary Chinese society is



The strength and success of these bonds rests at least partly on the invocation of the institutions of trust, loyalty and connectivity as described by Fei. However, the very flexibility of whom these bonds can be formed between is in itself a key feature of Chinese social connections. The most important factor is not the commonality seized upon but the talent of the individuals involved at building relationships. This flexibility is recognized even in the earliest works such as Fei's where after indicating that the familial bonds are so strong carries his analysis further to show that despite the strength of these bonds they can actually be discarded when they are not useful and be generated with others who are not members of the family. He indicates that a successful person is one that is good at "extending" himself<sup>27</sup>. That is, at extending his strong informal bonds.

#### **ALL THAT MATTERS IS WHETHER THERE IS A RELATIONSHIP**

Ultimately, in Chinese society what counts is whether two persons have the "guanxi" relationship and not whether they are family or school friends<sup>28</sup>. This means that it is not possible to describe a category of persons such as "relatives" in the law and hope to capture the majority of those that have strong informal bonds. The only way to describe them would be that associates are those that have a (say) "guanxi" bond but this does absolutely nothing to help identify those that do.

If a wide definition was drawn up to include the extensive blood relative network, old school and army associates, those from a common village or dialect then many may be included. However such a definition would be far too extensive to be workable and would include too many people that do not have any such relationship. Thus it is impossible to combat arbitrage and avoidance through the use of associates by focusing on associates when dealing with Chinese society. Associates while many and diverse cannot be identified.

#### **THE VALUE OF GUANXI IN A STRONG FORMAL INSTITUTIONAL ENVIRONMENT**

There is ultimately a great deal of value associated with doing business through informal institutions such as guanxi networks in a strong formal institutional environment. This value does not arise from the protection that informal institutions offer when there are no strong formal institutions as has been the case historically in China and South East Asia. Rather, it arises from the ability to avoid or reduce costs and obligations associated with strong institutional environments. The case here has been made in relation to taxation but it is clear that issues of liability to creditors and others are also relevant.

The fact that this demand for guanxi and networks in doing business in strong formal institutional environments such as Australia goes unmet on the part of the local "western" society is evidence in favour of the hypothesis that the use of guanxi is a cultural tool available to those with Chinese culture<sup>29</sup>. Otherwise why are strongly bounded networks of individuals not a feature of Australian business large or small? There are clear advantages to their use and, at least in the privately owned sector, not necessarily significant disadvantages at the level of the entrepreneurs themselves<sup>30</sup>. However, the inability to trust others without first having a formal relationship and

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<sup>27</sup> (Fei, 1992) Pg. pp 60 -70

<sup>28</sup> (Hendrischke, 2006; M.-h. M. Yang, 1994)

<sup>29</sup> (M. M.-h. Yang, 2002)

<sup>30</sup> This is not to say there are not disadvantages to the economy as a whole. There are.

record of specific rights is more a feature of these Australian entrepreneurs and their relationships with others.

The advantages of the use of informal institutions are actually maximized when other groups operating in a particular jurisdiction do not rely upon informal institutions as the reduced costs of taxation and potential liability give those operating through informal institutions a competitive advantage that is extremely significant. Of course, they have competitive disadvantages as well but these need to be valued against the massive advantages.

Thus the use of informal institutions such as guanxi networks should be expected to continue regardless of attempts made to strengthen formal institutions. This is because there is significant value associated with this modality of operation. This is regardless

- (e) a company where:
  - (i) the company is sufficiently influenced by:
    - (A) the primary entity; or
    - (B) another entity that is an associate of the primary entity because of another paragraph of this subsection; or
    - (C) another company that is an associate of the primary entity because of another application of this paragraph; or
    - (D) 2 or more entities covered by the preceding sub-subparagraphs; or
  - (ii) a majority voting interest in the company is held by:
    - (A) the primary entity; or
    - (B) the entities that are associates of the primary entity because of subparagraph (i) of this paragraph and the preceding paragraphs of this subsection; or
    - (C) the primary entity and the entities that are associates of the primary entity because of subparagraph (i) of this paragraph and because of the preceding paragraphs of this subsection.

*318(2) [Company]*

For the purposes of this Part, the following are associates of a company (in this subsection called the "primary entity"):

- (a) a partner of the primary entity or a partnership in which the primary entity is a partner;
- (b) if a partner of the primary entity is a natural person otherwise than in the capacity of trustee - the spouse or a child of that partner;
- (c) a trustee of a trust where the primary entity, or another entity that is an associate of the primary entity because of another paragraph of this subsection, benefits under the trust;
- (d) another entity (in this paragraph called the "controlling entity") where:
  - (i) the primary entity is sufficiently influenced by:
    - (A) the controlling entity; or
    - (B) the controlling entity and another entity or entities; or
  - (ii) a majority voting interest in the primary entity is held by:
    - (A) the controlling entity; or
    - (B) the controlling entity and the entities that, if the controlling entity were the primary entity, would be associates of the controlling entity because of subsection (1), because of subparagraph (i) of this



For the purposes of this Part, the following are associates of a partnership (in this subsection called the "primary entity"):

- (a) a partner in the partnership;
- (b) if a partner in the partnership is a natural person - any entity that, if that natural person were the primary entity, would be an associate of that natural person because of subsection (1) or (3);
- (c) if a partner in the partnership is a company - any entity that, if the company were the primary entity, would be an associate of the company because of subsection (2) or (3).

*318(5) [Time of association]*

In determining, for the purposes of this section, whether an entity is an associate of another entity at a particular time (in this subsection called the "test time"):

- (a) an entity (in this subsection called the "public unit trust entity") that, apart from this subsection, is the trustee of a public unit trust at the test time is to be treated as if it were a company instead of a trustee; and
- (b) the public unit trust entity is taken to be sufficiently influenced by another entity or other entities if the public unit trust entity is accustomed or under anome9s taken tust8f0.0035 Tc -1

might reasonably be expected to be, communicated directly or through interposed companies, partnerships or trusts); and

(c) an entity or entities hold a majority voting interest in a company if the entity or entities are in a position to cast, or control the casting of, more than 50% of the maximum number of votes that might be cast at a general meeting of the company.

318(7) ["Spouse"]

In this section, and in any other provision of this Act insofar as that provision has effect for the purposes of this section, a reference to the spouse of a person (in this subsection called the "first person") does not include a reference to a person who is legally married to the first person but is living separately and apart from the first person on a permanent basis.

#### **Section 995-1 (ITAA 1997)**

relative of a person means:

- (a) the person's \*spouse; or
- (b) the parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendent or \*adopted child of that person, or of that person's spouse; or
- (c) the spouse of a person referred to in paragraph (b).

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