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Influence from the Shadows : the OECD, The Shape of Domestic Tax Policy and Lessons for Federal Systems

Abstract

Over the years, the OECD has quietly taken centre stage in international tax policy development. The influence of the OECD is evident in the shape of Australian international tax policy. More recently, Australia has discovered that it can, in turn, have some influence in the direction taken by the OECD. This article examines some aspects of these influences. At a different level, the federal/state relationship is becoming tenser in the face of increasing tax competition. The second part of this article explores whether there are any lessons for federal tax systems that can be drawn from the way the OECD and similar organizations have helped the development of international tax policy. It is argued that an independent facilitator of tax policy, legislation and administration may prove beneficial.

Keywords

international tax policy, OECD, federal tax systems

INFLUENCE FROM THE SHADOWS: THE OECD, THE SHAPE OF DOMESTIC TAX POLICY AND LESSONS FOR FEDERAL SYSTEMS

by *Duncan Bentley**

Over the years, the OECD has quietly taken centre stage in international tax policy development. The influence of the OECD is evident in the shape of Australian international tax policy. More recently, Australia has discovered that it can, in turn, have some influence in the direction taken by the OECD. This article examines some aspects of these influences. At a different level, the federal/state relationship is becoming tenser in the face of increasing tax competition. The second part of this article explores whether there are any lessons for federal tax systems that can be drawn from the way the OECD and similar organizations have helped the development of international tax policy. It is argued that an independent facilitator of tax policy, legislation and administration may prove beneficial.

All the world's a stage,
And all the men and women merely players:
They have their exits and their entrances;
And one man in his time plays many parts...
Shakespeare, *As You Like It* II.vii.139

Introduction

The Economist recently reported that, 'The official Bush agenda has been to promote trade at the global, regional and bilateral level simultaneously.'¹ This reflects the state of world affairs. Interaction between players on the world stage has always been complex. Machiavelli explored the complexities in the art of statecraft in *The Prince*. Recently, the complexity has been exacerbated by the exponential growth in communication and technology. This is illustrated by the transmission of the conduct of the 2003 war in Iraq instantly to television screens across the globe in glorious technicolour.

* Professor and Dean of Law, Bond University.

1 'Bras, bolts and Brazil', *The Economist* (London), 22-28 November 2003, 35.

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The inter-connectedness of different participants in the conduct of world affairs remains the same. However, at all levels of policy development the number and range of stakeholders, influencers and participants has expanded with increased access. Protesters against globalisation, soccer hoodlums and supporters of Dr Howard Dean, a 2004 Democratic contender for the US presidential election, have all used the internet effectively for widely different causes. Although taxation can attract as much public attention when the question is whether to impose a poll tax, a goods and services tax or cut significantly the top marginal rates of income tax, the public attention waivers as discussion turns to technical detail.

It is in the exploration of that technical detail by policy makers, legislators, the executive and the judiciary that the ready access to a wide range of instant information, communication and influence has the potential to change dramatically the framework and the process of decision making. The Organisation for Economic Cooperation and Development (OECD) has exercised increasing influence in certain specific areas of tax policy development. Much of its influence can be attributed to the greater exposure that it has had because of instantaneous communication. The exposure leads to wider participation and engagement in the issues that it raises. Where once input into OECD policy and its influence was largely the province of governments and bureaucrats, the position has changed. The public can access significant quantities of information pertinent to tax policy making.² They can also participate in many of the debates that shape the development of OECD policy.

The first part of this article explores the influence of the OECD on aspects of Australian tax policy development and identifies those areas where improved communication and information technology have increased that influence. In the second part, the article explores aspects of the federal/state relationship in determining tax policy. It examines whether some of the issues that arise in that relationship could equally be influenced by international approaches taken by organisations such as the OECD.

Australia and the OECD

Australia has a medium-sized economy. It had the twelfth largest GDP in the OECD in 2002, slightly below the Netherlands and Korea.³ As a developed country, it has a sophisticated and complex tax system. The tax policy work of the OECD Committee on Fiscal Affairs (CFA) is highly relevant to Australia and the Australian Taxation

2 Available on the OECD Website at <<http://www.oecd.org>>.

3 <<http://www.oecd.org>>.

Office is a regular participant in and contributor to the many committees and working parties of the CFA. It is interesting to explore different areas of OECD interest to determine the effect that it has had on Australian tax policy development. Its influence is not consistent. It is pervasive.

Treaties

There are over 20 different types of tax treaty.⁴ In addition to the wide range of treaties dealing with individual taxes and individual activities (such as shipping and aircraft), there are multilateral treaties. Major multilateral treaties such as the *General Agreement of Tariffs and Trade* (GATT) also include clauses affecting taxation.⁵ By far the most influential, to date, have been the comprehensive bilateral double tax treaties on income and capital.

The growth in international trade and the lowering of barriers to trade have increased the importance of international transactions for all countries.⁶ Where trade barriers can be removed, there will always be a need for taxation to finance governments. The international economic convergence places strains on domestic tax systems, which have their own rules specific to their particular policy imperatives. For international transactions, however, it is important that economic convergence produces tax rules that do not inhibit increased economic activity.

The principles set out in the *OECD Model Tax Convention on Income and on Capital* (OECD Model)⁷ seek to:

Clarify, standardize, and conform the fiscal situation of taxpayers who are engaged in commercial, industrial, financial, or any other activities in other countries through the application by all countries of common solutions to identical cases of double taxation.

The idea of model bilateral conventions arose from the work of the League of Nations. The OECD took on the work carried out since 1921 to produce, in 1963, a

4 Diamond and Diamond, *International Tax Treaties of All Nations* (2000).

5 *Marrakesh Agreement Establishing the World Trade Organization, Legal Instruments – Results of the Uruguay Round* (1994) vol 1, 33 ILM 1125, 1144. See further <<http://www.wto.org>> and JH Jackson, *The World Trading System: Law and Policy of International Economic Relations* (2nd ed 1997).

6 For a broader discussion, see R Vann, 'International Aspects of Income Tax' in V Thuronyi (ed), *Tax Law Design and Drafting* (1998) vol 2, 718.

7 OECD Committee on Fiscal Affairs, *Tax Convention on Income and on Capital* (2000).

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draft model convention.⁸ The OECD Model in its current form was adopted in 1977 and is updated regularly.

Australia, along with most countries, uses the OECD Model as the basis for its international double tax agreements. The importance of the OECD Model is seen in the fact that most bilateral double tax treaties are not only based on it, but also follow its pattern and incorporate its main provisions. When the United Nations became concerned about inequalities in tax negotiations between developed and developing countries, it used the OECD Model as the basis for its own model treaty.⁹ Where Australia has incorporated provisions from the UN Model, it was not therefore required to diverge considerably from the OECD Model.

Australia's double tax treaties become part of domestic tax law under the *International Tax Agreements Act 1953* (Cth). However, the OECD Model is modified to suit Australia's particular relationships with its trading partners. In particular, those agreements negotiated with developing countries tend to place more emphasis on source country taxing rights. Also, until 1997, Australia often included tax sparing provisions in its agreements with developing countries. Since that date, government policy has changed and existing tax sparing provisions will not be renewed once they expire.

The Commentary on the OECD Model has proved influential in Australian judicial interpretation of its double tax agreements. In the 1990 case of *Thiel v FCT*,¹⁰ the Full High Court considered the meaning of an 'enterprise of one of the contracting states' under the Swiss double tax agreement. In interpreting the term, the High Court agreed that there was no settled meaning in Australian law. The High Court turned to the *Vienna Convention on the Law of Treaties* (Vienna Convention), although Switzerland is not a party, as it was held to express the general principles of international law. Under Article 32 of the Vienna Convention, the High Court found that it could have recourse to supplementary means of interpretation, including preparatory work on the double tax agreement. The High Court then held that the OECD Model and Commentary fell within this term.¹¹ This approach was followed again in *Lamesa Holdings BV v FCT*.¹²

8 OECD, *Draft Double Taxation Convention on Income and Capital* (1963).

9 United Nations, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (1980).

10 (1990) 171 CLR 338.

11 Taxation Ruling TR 2001/13 provides a comprehensive analysis of the views of the ATO on the interpretation of double tax agreements.

12 (1997) 97 ATC 4752; (1997) 35 ATR 239.

The OECD Model and its Commentaries are used by the Australian Government and the judiciary much as they were intended to be. They are a standard form basis for Australia's double tax agreements and are used in their interpretation. They are influential in the development of Australia's national tax policy and provide a useful framework. It would be wrong to see them as providing an obvious constraint, as Australia has voluntarily adopted the OECD framework. For example, developments in the OECD Model to deal with treaty shopping have been fairly limited. Australia has gone beyond the OECD Model using specific anti-treaty shopping provisions, for instance, in its double tax treaty with the United States.

Although the influence is strong, Australia does not follow its treaty obligations where it feels that they are counter to national interest. Evidence of this can be seen in the approach taken by the Australian Government, following the immigration case of *Minister for Immigration and Ethnic Affairs v Teoh*.¹³ The Court found that there was a legitimate expectation that the Australian Government intends to abide by its international treaty obligations unless it expressly states otherwise. The *Administrative Decisions (Effect of International Instruments) Act 1997* (Cth) reversed this position and removed the application of legitimate expectation in this area. The Australian Government refused to be constrained in its domestic policy by its treaty obligations.

Legislation

In areas of legislation and administration designed to protect the fisc, Australia has followed, voluntarily, internationally accepted norms,¹⁴ particularly those recommended by the OECD. Australia has used the traditional designation of taxpayers as resident or non-resident to determine their tax treatment. It has similarly applied the concept of source to its treatment of income. Income is taxed differently depending upon whether it arises from a domestic or foreign source. This has, of course, given rise to different treatment of outward and inward transactions, as these are subject to taxation in other jurisdictions. Australia's treaty network, based on the OECD Model, was developed to deal with double taxation and double non-taxation of income arising in Australia and one or more other jurisdictions.

With the growth of international trade and transactions, the tax treaty network has not been sufficient to capture all transactions within the tax net. The Australian

13 (1995) 183 CLR 273.

14 For an analysis of these norms see Vann, above n 6, 720 and R Rohatgi, *Basic International Taxation* (2002) ch 1.

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system itself, in common with other sophisticated systems, needed to develop a broader framework of rules. Increasingly, Australia has looked to its fellow OECD members and agreed OECD guidelines as it has developed its own legislation in areas affecting international transactions. The focus has been on developing anti-avoidance rules to ensure that there is little opportunity for taxpayers to take advantage of double non-taxation rather than on measures to converge Australia's taxing rules with those of other OECD members.

Australia's transfer pricing rules provide an example of the influence of the OECD. Designed to prevent profit shifting between jurisdictions to take advantage of a more favourable tax environment, there were concerns that application of the different transfer pricing regimes would lead to double taxation, thereby hindering the expansion of trade. The 1979 OECD Report, *Transfer Pricing and Multinational Enterprises*, gave a common definition for the arm's length principle that underlies most transfer pricing regimes. There was much subsequent argument over the definition. However, Australia, along with the other OECD members, adopted the 1995 OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. These have been instrumental in determining the ATO interpretation of Australia's own transfer pricing legislation. The Commissioner's approach is set out in a number of detailed rulings.¹⁵ They set out the theory behind Australia's approach to transfer pricing, based closely on the OECD guidelines, before setting out the steps to determine and document an arm's length price.

Australia has been in the forefront of common practice among OECD member countries to counter tax avoidance. It implemented legislation covering thin capitalisation early on to overcome hidden equity capitalisation through excessive loans.¹⁶ In 2001 it updated this legislation in light of international developments, to ensure its continued effectiveness.¹⁷

In 1990, Australia followed the example of other OECD members and introduced a comprehensive accruals taxation system to tax residents on their share of income derived offshore that was not taxed comparably to similar income in Australia. The accruals system centred on provisions governing controlled foreign companies and foreign investment funds. The Canadian tax expert, Professor Brian Arnold, was commissioned to advise on the draft legislation prior to its implementation, based on

15 See, for example, Taxation Ruling TR 97/20 on the transfer pricing methodologies that apply to international dealings between separate legal entities and related Taxation Rulings TR 94/14, TR 98/11 and TR 99/8.

16 CFA, *Issues in International Taxation No 2 – Thin Capitalisation* (1987).

17 *Income Tax Assessment Act 1997* (Cth) div 820.

his experience of similar legislation in Canada and other OECD member countries.¹⁸ The legislation for controlled foreign companies relied on the tax systems in place in seven OECD member countries to place them on a list of favoured jurisdictions that are treated as having comparable tax systems to that in Australia.¹⁹

In 2000, Australia followed the example of the other member countries of the OECD (with the exception of the US), and introduced a consumption tax. It followed the standard structure of consumption taxes elsewhere in the OECD and the systems operating in Canada and New Zealand, in particular, formed a useful reference point in the design of the legislation.

Australian tax policy is primarily focused on domestic imperatives. However, when there are international implications, Australia tends to look to its major OECD partners, particularly those with similar tax systems, to provide a comparative perspective.²⁰ OECD initiatives and guidelines are influential in determining the shape of the final policy. This is inevitable, given the pressure of globalisation and the convergence of international tax systems of the major trading nations. The international constraints on national tax policy tend not to be overt, but set the framework for policy. Moving outside that framework raises the risks of unintended and sometimes detrimental consequences that most democratic governments prefer not to take.²¹

18 B Arnold, *Report on the Implementation Issues Arising from the Foreign Investment Fund Legislation* (1992) and the Federal Treasurer, 'Foreign Investment Fund (FIF) Legislation: Government Response to Consultant's Report' (Press Release, 9 October 1992).

19 *Income Tax Assessment Act 1936* (Cth) reg 152J, sch 10.

20 See B Arnold, 'The Process of Tax Policy Formulation in Australia, Canada and New Zealand' (1990) 7 *Australian Tax Forum* 379 and the major Government sponsored review by J Ralph, *Review of Business Taxation* (1999), <<http://www.rbt.treasury.gov.au/publications/paper4/index.htm>>.

21 See the discussion in K Messere, *Tax Policy in OECD Countries: Choices and Conflicts* (1993) 28.

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Tax administration and policy development

It is in the areas of tax administration and policy development that Australia has been most influenced by the OECD. Largely, this is because it sees itself as a leader in these areas.²² This has been most clearly shown in the area of electronic commerce.

Electronic commerce highlighted the gaps in the existing tax rules.²³ Those operating outside the rules could do so more easily.²⁴ There were no clear rules governing electronic commerce and this led to a breakdown in tax sovereignty. The potential size of the gap from a revenue perspective was significant, given that once a business sets up a website, it has a potential global customer base. The gaps in the rules were gaps of omission. However, unlike the non-taxation of capital gains in New Zealand, the gaps were unintentional. This represented potential revenue leakage and the tax authorities of the OECD member states were quick to act and Australia was a leading participant.

They faced two problems. First, commercial transactions are largely carried out by fictional entities such as companies, trusts and foundations. Fictional entities have limited physical presence or links with a particular jurisdiction. They may be incorporated, constituted or settled in one country, yet operate exclusively in another or several other countries. The special rules that have been devised to allocate taxing rights are subject to physical connections that do not exist in cyberspace. Where is the permanent establishment of a company that operates largely on the Internet? If a company is a fiction in real-space life, its fictional persona is open to extensive manipulation in cyberspace life.

Second, they had to allocate the income arising from electronic commerce between sovereign states. The special rules devised to allocate income are also artificial constructs. Nations can assert tax sovereignty more easily over an individual who

22 A review of the speeches of the Commissioner of Taxation, Michael Carmody, available at <<http://www.ato.org.au>> clearly demonstrates this view. In developing its role in the area, the ATO also works outside the OECD in regional bodies, such as APEC (Asian-Pacific Economic Co-operation). See M Carmody, 'International Business Taxation – An Administrator's Perspective' in R Vann, *Taxing International Business: Emerging Trends in APEC and OECD Economies* (1997) 9.

23 FM Horner and J Owens, 'Tax and the Web: New Technology, Old Problems' (1996) *Bulletin of the International Bureau of Fiscal Documentation* 516. For a more extensive analysis of this issue, see D Bentley, 'The ATO, Tax and the Internet: The Emperor's New Clothes?' (1999) 9 *Revenue Law Journal* 99.

24 For a general analysis, see L Lessig, *Code* (1999).

operates in Cyberspace than over a fictional entity. The individual may escape that regulation through criminal means: hiding transactions and evading tax. There exists, nonetheless, a physical link or presence that allows the sovereign to enforce its regulation. However, because the rules allocating tax sovereignty between different jurisdictions are artificial, to overcome a dual link or presence, those rules can be manipulated using electronic transactions.

The OECD called a meeting of its members in 1997. At the meeting it was stated that:²⁵

The challenges posed to tax systems by Internet Electronic Commerce are real and governments will need to focus on how to address them in a spirit of collective co-operation. The allocation of taxing rights must be based upon mutually agreed principles and a common understanding of how these principles should be applied. Even if such a consensus is achieved, governments may find that their ability to enforce taxation may be diminished. Without such a consensus, the Internet and other new communication technologies may pose a serious challenge to governments in maintaining their revenue bases.

The CFA acted as a catalyst to generate discussion using a multi-disciplinary approach involving all its Working Parties.²⁶ Both in the Working Parties and in wider discussions the CFA included a range of participants outside the member country delegates, particularly business representatives. The idea was to try and develop a consensus on solutions that went beyond the OECD member states.

National governments began to issue reports on the taxation of electronic commerce.²⁷ The ATO produced two major reports in 1997 and 1999.²⁸ As the country reports identified the seriousness of the international threat to traditional concepts of income allocation and tax administration, they looked to increased co-operation to reach a solution. In October 1998, the OECD Ministerial Conference endorsed a

25 OECD, 'Electronic Commerce: The Challenges to Tax Authorities and Taxpayers', (1997 OECD), a paper presented at an informal round table discussion between business and government in Turku, Finland. Available at <http://www.oecd.org/daf/fa/e_com/e_com.htm>.

26 Horner and Owens, above n 23,523.

27 For example, US, The White House, *A Framework for Electronic Commerce* (1997), EU, *A European Initiative in Electronic Commerce* (1997), Canadian joint Government/Business report on *Electronic Commerce and Canada's Tax Administration* (April 1998) <<http://www.rc.gc.ca/ecomm/>>.

28 *Tax and the Internet* and *Tax and the Internet: Second Report – December 1999*, both available at <<http://www.ato.gov.au>>.

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framework for discussion of taxation of electronic commerce.²⁹ The OECD Taxation Framework Conditions have been widely accepted. Australia was represented on a number of the Technical Advisory Groups (TAGs), set up under the Taxation Framework Conditions. It was also heavily involved in policy development through the CFA. The Australian Reports closely follow the recommendations of the TAGs at the time and adopt the Ottawa Taxation Framework Conditions as the basis for the ATO approach.

In the Second Report, the ATO outlined its agenda. It aimed to use the technologies underlying electronic commerce to: support the implementation of tax reform; improve service to the community; support business on-line; improve the efficiency of the ATO; and contribute to international best practice in tax administration. These aims were reflected in the Action Plan 'Service Strategy S.1 – Improving service standards'.³⁰ Largely, it has achieved its objectives and remains a leader in this area within the OECD. Without the electronic platform, the delivery of major tax reform in 2000 and 2001 would have faced serious difficulties.

The TAGs, in which Australia has played a leadership role, have also proved extremely successful in several areas. There has been an agreed clarification to the OECD Model interpretation of the definition of permanent establishment.³¹ There has been a widely accepted report on treaty characterisation issues.³² A number of other reports provide steps towards consensus on contentious issues.³³

Australia brings its experience in leadership in international policy development to the Forum for Strategic Management,³⁴ established under the auspices of the CFA for senior tax administrators of member states. The ATO has apparently established a website for the Forum 'where revenue authorities can exchange views on

29 CFA, 'A Borderless World – Realising the Potential of Electronic Commerce' a report presented on 8 October 1998, (OECD Taxation Framework Conditions) available at <http://www.oecd.org/daf/fa/e_com/ottawa.htm>. See also, OECD, *Electronic Commerce: A Discussion Paper on Taxation Issues*, a paper presented for discussion at the OECD Government/Business Dialogue on Taxation and Electronic Commerce held in Hull, Quebec, Canada, on 7 October 1998.

30 Second Report, above n 28, 13.

31 See <<http://www.oecd.org/daf/fa>>.

32 Ibid.

33 Ibid. See further, OECD Press Release, 12 February 2001, 'OECD Progresses towards Achieving an International Consensus on the Tax Treatment of E-commerce'.

34 Second Report, above n 28, para 4.6.3-4.6.5.

strategically important tax management issues'.³⁵ The ATO believes that, 'the capability to provide ready access to best practice and facilitate virtual interaction... Are critical enablers for dealing with a dynamic globalising environment'.³⁶

Most important for this discussion, The ATO has helped to set the international policy framework in electronic commerce through its participation in the OECD. As it grows in its role as one of the influencers of international tax policy, it is inevitable that Australia will buy into the policy changes put forward by the OECD on a wider range of issues. As Australia influences the OECD, so the OECD will become a stronger influence on Australian international tax policy.

OECD influence

The influence of the OECD in tax matters has increased substantially over the years as it has taken a leading role in developing tax policies to meet the challenges facing its members. For Australia, it provides an opportunity to participate in international policy development with the major economic powers. It is inevitable, therefore, if Australia is to remain a player within the OECD in tax matters, that the Federal Government will largely conform its international tax policy approach to that of the OECD.

The success of the OECD Model as a basis for Australian and other countries' double tax agreements shows that there is much to be gained from policy convergence of this kind. Implementing agreed OECD policy approaches at a legislative level has also been successful for Australia. The broad framework within which the OECD operates allows significant room for national idiosyncrasy. However, the convergence is sufficient for Australia, for example, to identify companies operating in its major OECD partners as being comparably taxed under its controlled foreign company rules, thereby reducing significantly the administrative burden for companies operating in those jurisdictions. Similar benefits apply in other areas.

Australia's approach to electronic commerce is a useful example of how the OECD does influence national tax policy. Australia is not in the position of the US or the EU, where it can dictate international policy. It therefore relies on international fora such as the OECD as arenas to put forward its ideas. In an area such as electronic commerce, Australia has recognized that international agreement is essential to protect both trade and revenue. It is also an area where Australia has a competitive

35 Ibid, para 4.6.4.

36 Ibid.

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advantage. The ATO has capitalized on this opportunity to invest time and resources in the policy development program within the OECD.

In this way, it can put forward its own ideas and those of its constituents in taking the policy discussion forward. As a leading member of OECD policy development teams the ATO achieves an influence far beyond Australia's economic weight. However, it also has to take considerable ownership of the policies put forward. To reject them wholly or in large part would likely undermine Australia's credibility and reduce the ATO's influence in future discussions.

Australia uses the dialogue within the OECD to take forward its own policy agenda at an international level. By participating, it reduces its facility to act outside the OECD international tax policy framework. Constraints are inevitable if a country (particularly an economically small country) wishes to participate fully in international trade. It is simply the extent to which they apply. The advantage of voluntarily operating within those constraints is that it provides a greater opportunity to influence future developments. Australia has chosen the latter course.

Lessons for the federal/state relationship

Do any of these broader international approaches translate into a federal/state environment? In many ways the federal/state relationship in most OECD countries has reached a level of sophisticated convergence that the question should perhaps be the other way round. However, it is partly because the federal/state relationship has been in place in many jurisdictions for such a long time that there may be some innovative ideas that could translate from the international environment to enliven and enlighten federal/state relationships.

The federal/state relationship depends very much on the model of government developed in the relevant jurisdiction. In federal systems, there is normally a level of government below the central government that has power over many of the functions carried out by the central government in a unitary system. For example, state or provincial governments³⁷ in federal systems may have primary responsibility for matters such as health and education. This second level of government usually has many of the features of a central government in a unitary system. In OECD member countries, this would include a democratic government and the separation of powers. Tax revenues are as critical to the operation of state governments as they are to any other form of government exercising national responsibilities.

37 I refer to this level of government using the term 'state government' for simplicity.

Background

Australia provides a good example of the tensions that occur where taxing powers overlap.³⁸ Section 51(ii) of the Australian Constitution gives concurrent taxing powers to both the Commonwealth and the states. Historically, the states were more powerful. Recall that federation only took place in 1901. At that time, with the introduction of a federal constitution, the states lost their power to levy customs and excise duties.³⁹ This increased their reliance on income tax. In 1920, the Kerr Commission made the first attempt at harmonisation. The Commonwealth Government, meanwhile, was finding the limits on its taxation powers restrictive. The Ferguson Royal Commission was appointed in 1932. The 1936 Income Tax Assessment Act was introduced as a result. It provided comprehensive coverage of income taxation and was introduced in both the Commonwealth and the states.

During World War II, the federal government introduced a scheme that effectively prevented the states from imposing income tax. Although challenged as unconstitutional, it was upheld on two occasions. Agreement was reached on a sharing of income tax revenue between the Commonwealth and the states. Since then, the states have never exercised their right to impose income taxation. However, tensions rose over the years because of the quantum of tax revenues available for sharing among the states. Various indirect taxes were levied both by the Commonwealth and the states. Agreement was eventually reached to introduce a consumption tax (Goods and Services Tax or GST) from 1 July 2000. This required the abolition of most indirect taxes. In return, the states were given the revenue from the GST. The sharing formula was contested, but a potentially significant increase in revenue made agreement achievable.

The Australian example raises a number of issues. It is interesting to note that many are also reflected internationally. A primary issue is the power to tax. The central government prefers to retain that power as a measure of control over the economy.⁴⁰

38 For an overview of the history of taxation in Australia, see C Coleman and M McKerchar, 'The Chicken or the Egg?: A Historical Review of the Influence of Tax Administration on the Development of Income Tax Law in Australia', paper presented at the Tax History Conference, 4-5 September 2002, Cambridge, UK; RH Woellner et al, *Australian Taxation Law* (12th ed, 2002), ch 1 or J Waincymer, *Australian Income Tax Principles and Policy* (1993) ch 3.

39 Section 90 of the Constitution.

40 Although there have long been arguments that economic welfare can increase through different local tax and public spending regimes. See CM Tiebout, 'A Pure Theory of Local Expenditures' (1956) 64 *Journal of Political Economy* 416. Analyses of the federal/local

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Otherwise, state tax expenditures can increase. State taxation must then increase with it and the level of concurrent taxation may impede national economic growth.⁴¹

Centralisation of taxing power does not necessarily remove the right to tax using other types of tax, such as property taxes, levies and charges. However, it does mean that there must be a reallocation of tax revenue to meet state expenditures. This can take place through grants or a formulary revenue allocation. Messere points out that most OECD countries do not consider the funding of expenditure through deficits legitimate over the long-term.⁴² As states impose non-income taxes, levies and charges, they must be administered and collected efficiently to ensure a stable revenue base. Therefore, critical to the operation of a federal system is the jurisdiction to tax and the types of taxes imposed, their efficient administration and collection, and the allocation of revenues.

Jurisdiction and types of tax

The jurisdiction issue has wider ramifications than simply the state/state and federal/state relationship matrix. State/other country and state/international investor relationships are now important. For example, the Australian state of Queensland may have competing interests (elements of which may be mutually exclusive). Queensland has to satisfy its relationships with the other Australian states. It also has to provide incentives to foreign direct investors and remove indirect trade and other barriers to develop closer ties with regional neighbours. The basic jurisdictional relationships are usually far stronger than those that are external. But it is the strength of that commonality that requires the differentiation to allow the states to compete economically.⁴³

States are generally limited in their ability to tax and the types of taxation that they can use. To compensate, states use other methods of tax. Often the state or local level tax is disguised as a tariff or other barrier not defined as a tax, such as licence fees and fuel levies. On the other hand, competition may result in amelioration of taxes for investors that the state wishes to attract, for example, tax holidays for stamp duties and land taxes for multinational headquarter companies. Australian states are

tension are found in P Prudhomme, 'The Dangers of Decentralisation' (1995) 10 *World Bank Research Observer* 201 and RM Bird, 'Threading the Fiscal Labyrinth – Some Issues in Fiscal Decentralisation' (1993) 46 *National Tax Journal* 207.

41 See further the discussion in Messere, above n 21, ch 9.

42 Ibid, 192.

43 For a wider discussion, see S Bucovetsky, 'Rent Seeking and Tax Competition' (1995) 58 *Journal of Public Economics* 337.

open to negotiation with significant international investors over state taxes and other imposts.⁴⁴

Even within a sovereign jurisdiction the principle of comparative advantage remains. The power to tax is one of the few tools left to government to influence the local economy. To the extent that the taxing rights rest with an authority, the authority will do its utmost to preserve its tax autonomy unless there are demonstrable advantages in doing so. For example, the funding of the states in Australia through the GST was arguably instrumental in gaining political acceptance for its implementation. Conversely, when a proposal was put forward to create a uniform stamp duties act for all Australian states, only some were willing to participate. The rest could not see the advantage in giving up their autonomy. But this demonstrates the need, where there is a change in system, to protect the interests of all those affected by the change, or it will not be accepted. Although, generally, there are constitutional protections to prevent override by the federal authority, it is the understanding by all parties of the necessity for a common approach that is a lesson that can be drawn from the work of the OECD.

The global tax position is similar to the local. There is now a range of relationships at different levels that affects a country's power to tax. Increasingly, competition limits the scope of domestic tax policy. The influence of international organisations limits that scope still further. The international organisations can only do so, however, because they are seen as relatively impartial and broadly pursuing a common benefit. Within the federal/state relationship this does not occur, as the federal government is usually pursuing its own agenda and cannot act as an 'impartial' arbiter or facilitator. Perhaps an independent policy facilitator could perform that task at the local level as effectively as the OECD has done internationally? Independent central banks are the archetype that proves that it is at least feasible.

Administration and collection

States face similar problems federally in administering and collecting taxes, as countries do internationally. Because of their commonality of interests, there is usually at least as much co-operation between states as occurs in economic groupings such as the EU. However, as soon as there is autonomy, there still needs to be

44 China provides another example of negotiation with investors. See, A Shu and J Yang, 'China enacts incentives to encourage information technology, innovation and developments' (2000) 20 *Tax Notes International* 829. See also, L Zaheng, L Wang and M Gould, 'China establishes special trade zones to encourage export operations' (2001) 22 *Tax Notes International* 589.

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agreement on how co-operation can occur. Where systems and taxes differ, co-operation can be difficult to achieve. Take, for example, the problems that have arisen in the US for states attempting to collect taxes in other states. There is the dual problem of federal and other state concerns over the legitimacy of the taxes and jurisdiction both to tax and collect taxes.⁴⁵ Often, in this situation, there is a federal override of the states' powers.

It occurred in Australia with the income tax when the Commonwealth effectively took control of the income tax. It has occurred through the courts in the US, where the Commerce and Due Process Clauses in the US Constitution have been used by the Supreme Court to limit the taxing rights of states.⁴⁶ The Federal Government in the US has also used significant influence to pass the *Internet Tax Freedom Act*.⁴⁷ The Act places a moratorium on Internet taxation until agreement is reached as to what taxation should occur. For example, it bars state or local governments from taxing Internet access and from imposing taxes that would subject buyers and sellers of electronic commerce to taxation in multiple states. The states have been discussing an appropriate policy approach but failed to reach agreement before the end of the three year moratorium. President Bush extended the moratorium in 2001. The original authors of the Internet Tax Freedom Act are intent on introducing legislation to make the moratorium permanent.⁴⁸ This will effectively limit the states' taxing powers in the area, largely because they have failed to reach consensus.

Federal intervention does not necessarily solve the difficulties raised through state tax competition. Pope argues that the major tax reforms in Australia in 2000 have exacerbated tax competition between states in Australia.⁴⁹ This places a heavier burden on the administration and collection of state taxes.⁵⁰ However, when it comes

45 These issues are discussed at length in W Hellerstein, 'Roles Of States/Provinces in Taxation in the Canada/U.S. Context' (2001) 27 Can USLJ 75 and W Hellerstein, 'Transaction Taxes and Electronic Commerce: Designing State Taxes That Work in an Interstate Environment' (1997) L (3) *National Tax Journal* 593.

46 For example, *Quill Corp v North Dakota* 504 US 298 (1992).

47 For a history, the full text, summary and recent developments, see <<http://cox.house.gov/nettax>> and links. See also, MG McLaughlin, 'The Internet Tax Freedom Act: Congress Takes a Byte Out of the Net' (1998) 48 *Catholic University Law Review* 209.

48 Ibid.

49 J Pope, 'State Tax Competition in Australia: An Applied Perspective', paper presented at the 12th Tax Research Network Conference, 5-6 September 2002, Cambridge, UK, 21.

50 See generally, N Warren (ed), *State Taxation, Repeal, Reform or Resignation* Australian Tax Research Series No 21.

to the administrative detail the state revenue authorities appear to be driven by the practical need to protect the fisc. The close links developed over many years between different state revenue authorities provide the model to which international organizations, such as the OECD, aspire for their members. It is in the policy and legislation governing administration and collection that arguments for an independent policy facilitator apply most strongly. However, once such a facilitator was accepted, it would make sense to extend its terms of reference to cover the improvement in administration and collection of revenue among the parties. It could raise the bar for standards of co-operation that could be achieved.

Allocation of revenues

The allocation of revenues among states in a federal system raises the same issues as allocation of revenues among nations.⁵¹ However, the allocation of tax revenues between different levels of government has been going on longer, there is greater commonality in most systems and the mechanisms are more sophisticated with better facility for appropriate information sharing. Formulary apportionment in federal systems is common, whereas it has received limited acceptance in some regional groupings and is widely rejected at the international level.⁵² A different environment can produce a different perspective. In a federal system, the mechanism for apportionment is accepted but tensions rise over discussion of the formula. However, in the end, the ties of nationhood ensure that, in most cases, agreement is reached. As soon as the relationship between the parties has sufficient investment in it, revenue sharing becomes possible. The parties cannot afford the relationship to break down and their links are too close to make a standoff feasible. This is increasingly the case within the EU for aspects of revenue sharing. However, as the EU Commission and OECD encourage such allocation at the international level, there is, again, at the state level, no independent facilitator. It may be that the tensions at the state level would be ameliorated by the presence of an independent facilitator in the allocation of revenues. The negotiation may be no less difficult, but an allocation under the auspices of an independent facilitator could be seen as fairer than that achieved by force of necessity.

51 MJ Graetz and MM O'Hear, 'The 'Original Intent' of US International Taxation' 46 *Duke Law Journal* 1021.

52 Messere, above n 21, ch 9; BJM Terra and PJ Wattel, *European Tax Law* (2nd ed 1997) ch 11; 'EU Commission, Member States Commit to EU-Wide Company Taxation, Formulary Apportionment' (2001) 26 *Tax Notes International* 515.

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Lessons from the international environment

It is likely that external pressures will encourage reinforcement of federal/state commonality, given the clear advantages of free trade and removal of trade barriers at that level. The challenge will be to determine whether competition or mutual self-interest will prevail. The latter will allow the joint reduction of internal trade barriers in the form of taxation or the common use of taxation as a policy tool within a federal environment, as has increasingly occurred in Australia. Compare the US, where different state systems still apply and there is nervousness about experimenting with reform of the tax mix in such a complex economy.⁵³

It is almost inevitable that external competition will continue to encourage convergence of taxes affecting inter-state trade and transactions, as has happened with the harmonisation of Australian stamp duty and the US attempt to introduce a common approach to the taxation of electronic commerce. However, in areas unaffected by the demands of trade, where there is autonomy, individual systems are more likely to remain with little federal/state tension, for example, land tax on residential investment properties.

The lessons from the changing international tax environment appear, in general terms, to reinforce the long-held views of public finance theorists.⁵⁴ Jurisdiction to tax is a legal and political issue. But practically, there is a trend towards centralising control. The criteria for good state and local taxes focus on lack of mobility of the tax base. This is evident in the debate over state taxation of electronic commerce. It is also relevant to the administration and collection of taxes. Increased mobility of taxpayers and transactions requires the greater levels of co-operation now also being sought at the international level, or a relinquishing of the administration and collection function of the taxes with a more mobile tax base, as has occurred in Australia. The critical factor remaining is the allocation of income between the federal constituents. In this area, in particular, the federal experience provides a useful model for those seeking to extend it internationally.

Conversely, in the management of federal/state relationships, the international experience provides a useful model that could reduce the tensions that often arise. Independent policy institutions that act as facilitators in the development of policy

53 J Guttentag, 'Emerging Issues in Taxing Business in a Global Economy', in Vann, above n 17, 67, 75.

54 For example, R Musgrave, *The Theory of Public Finance* (1959); CE McLure (ed), *Tax assignment in Federal Countries* (1983); and JP Owens and S Panella, *Local Government: An International Perspective* (1991).

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and administration for their members have been increasingly useful and successful in specific areas at the international level. Whether federal governments would give up any element of control to an independent policy facilitator is questionable. However, given the success of such bodies at the international level it would be an idea worth exploring to improve revenue policy, legislation and administration within federal systems.