3

Effects of the globalisation of international financial markets on economic policy

3.1 The effects of the Asian Financial Crisis were a timely reminder for Australia that in today's globalised financial system no country can truly operate independently. Major economic decisions are scrutinised in detail by world markets and can have an immediate effect on currency and share values.

3.2 This means that the rapid progress of world economic integration poses a growing series of challenges for government policy makers. The Treasury submission to this inquiry noted that:

> The driving elements of economic activity – capital markets, technical innovation, corporate organisation, and trends in consumer demand – are increasingly crossing national boundaries as governments, societies, firms and individuals strive to maximise the advantages presented to them by economic integration.
>
> These developments –loosely termed as 'globalisation' – offer real benefits to those who participate in the international economy. Globalisation, however, also poses real risks as decision-makers, in government and business, adjust to an ever-more complex economic environment.[1]

3.3 In his evidence to the Committee, Dr John Edwards commented that the trend was towards major economic decisions being taken by "shifting coalitions of nation states, regulators [and] global institutions." He

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1 Submission 13, The Treasury, p.1.

wondered whether this might be an opportunity for smaller players like Australia, to have an important role in the process.[2]

3.4 Dr Edwards speculated that in the long term, economic globalisation "is really about creating a single global economy in which, over time, nation states are deprived of former functions." He added that the debate over what nation states are and what they should do, could be under way within a decade. He concluded:

> … what I really mean is that the only economic power of successful globalisation is achieved by merging your economy with others.[3]

Dealing with global financial markets

3.5 An area of government activity especially affected by the changes in global financial arrangements, particularly by the recent spectacular advances in the speed of communications, is the control of national financial systems. The rapid changes in international financial markets and the increasing speed of international transactions, have made the continuation of a completely independent policy virtually impossible for any length of time.

3.6 The growth of trans-national companies, the world-wide spread of Internet access, the availability of virtually instantaneous funds transfer (with all of these linked to twenty-four hour a day access to stock and currency markets around the world) have presented economic administrators with major problems in controlling the stability of their national systems:

> Financial markets have become interconnected in several ways. First of all, on-line transactions and computer-based information systems allow for very fast movements of capital between financial products, currencies and countries – often in a matter of seconds. Second, new financial products have appeared, mixing valuables from various countries to be traded in other countries. When one component of these products is affected by a sudden change in value in one market, it affects the product as a whole, in a range of markets. This was particularly the case of derivatives in Asian financial markets in 1997. Third, speculative investors looking for

2 Evidence, Dr J. Edwards, 22 March 2000, p.99.

3 Evidence, Dr J. Edwards, 22 March 2000, p.100.

> high financial rewards move swiftly from one market to another, trying to anticipate price movements of different products in different currencies, using forecasting models.[4]

3.7 In particular, the volatility of short-term speculative investment funds has tested the ability and resolve of regulatory authorities several times in recent years. The rapid movement of these funds and the instability it brings, were features of the onset of the Asian Crisis of 1997-98. It characterised what has been called "the first global crisis of the Internet era."

3.8 One of the catchcries of those opposed to globalisation, is that the process reduces a government's ability to maintain control of its own economy. The Treasury claims that Australia's performance during the Asian Crisis has weakened this argument. Strong economic fundamentals have proved to be a good insulating mechanism against the more dramatic fluctuations of global financial markets but, as Treasury acknowledges, the market is quite able to punish those economies pursuing inappropriate policies.[5]

3.9 To be effective and to be accepted as appropriate by world financial markets – what author Thomas Friedman calls the electronic herd[6] – policies must be soundly based, credible and transparent. Treasury suggests they must be supported by a strategy which minimises the opportunities for capricious and arbitrary actions in the market to undermine them. Fortunately, "there appears to be very little conflict between what is valued by international financial markets and what is in Australia's best interests," according to Treasury's assessment.[7]

3.10 Critics claim, however, that globalisation introduces distortions into the economy, such as widening the dispersion of income and interfering with employment growth. Treasury said that it is unfortunate that often the real potential for globalisation to improve welfare, both nationally and internationally, is overlooked by its critics.[8]

3.11 It must be recognised, of course, that any major structural change is going to affect some individuals and businesses badly. There is a very positive role for government to play in redressing this situation. The globalisation process involves the movement of scarce resources into sectors yielding the highest return and the strongest and most stable employment growth.

4 Manuel Castells, *Information Technology and Global Capitalism*, in Eds Will Hutton and Anthony Giddens, On The Edge: Living with Global Capitalism, Jonathan Cape, London, 2000, p.55.

5 Submission 13, The Treasury, pp.1-2.

6 Thomas Friedman, *The Lexus and the Olive Tree*, Harper Collins, London, 1999, p.94

7 Submission 13, The Treasury, pp.1-2.

8 Submission 13, The Treasury, p.7.

> To balance this process, there is a need for assistance to those directly affected, especially those who need retraining or relocating and those employees too old to change careers.[9]

3.12 The Committee asked Treasury directly whether the globalisation of international financial markets reduces the government's scope for independent policymaking, Treasury responded: "No, it does not." After explaining that globalisation today is not much different from similar circumstances at the end of the 19th century and the beginning of the 20th century, except in the speed of communications and the size of gross capital flows, Treasury said:

> Your question is: does that mean that domestic governments or national governments have less power to set national economic policy?
>
> The evidence is that it does not mean that. National governments are every bit as activist in setting national policies now as they ever were, perhaps even more so. It does mean that national governments will have an eye and should have an eye to international perceptions of their policies. But our view would be that it would be hard to run an argument – certainly in Australia's case – that what is seen to be good by international investors is not good for Australia. People will run that argument but, to my mind, not at all convincingly.[10]

3.13 The Committee does not fully share Treasury's optimism about the independence of policy making as far as macroeconomic policy is concerned. The evidence shows that macroeconomic policy is converging around the world and that international financial markets react badly to unsatisfactory policies, such as large budget deficits.

3.14 Treasury then explained that what international investors look for in the Australian (or any other) economy, is strong, sustainable growth that does not give rise to inflationary pressures or unsustainable current account deficits. If asked what Australia would like to see in its economic performance, Treasury said, "we would say much the same thing" and concluded that:

> … Governments have to pay attention to the views of international financial markets. That is certainly true and there is, therefore, a discipline that is placed on governments through the operation of

9 Submission 13, The Treasury, p.31.

10 Evidence, The Treasury, 13 March 2000, p.40.

> international financial markets. It is difficult to run an argument that there is something wrong with that discipline.[11]

A similar conclusion could be drawn from the experiences of State governments in recent years.

Effects on monetary and fiscal policies

3.15 Australia's current monetary and fiscal policies were developed in response to the growing internationalisation of the economy. The spread of globalisation, bringing with it increased mobility of capital flows, demanded a policy solution which could provide both:

- integration with the world economy; and
- stability.

3.16 Treasury's submission highlighted the dangers for the Australian economy in the increased level of volatility in international capital flows. If the international instability affected the Australian market, it could increase business and investment uncertainty, lead to higher risk premiums on equity and long-term debt, deter foreign trade and long-term direct investment and, possibly, increase the risk of financial system failure.[12]

3.17 Those reasons alone were sufficient to justify a close examination of Australia's monetary and fiscal policies. In 1997-98, however, an additional incentive was added. As the Asian Crisis spread, the international markets began to bracket Australia with countries suffering severe difficulties – Korea, Indonesia, Russia and Brazil. It became essential to demonstrate the soundness and stability of the Australian economy.[13]

Monetary policy

3.18 In the period from the 1960s to the early 1990s, under pressures generated by changes in international markets, monetary policy in Australia went through several transformations. By the mid-1980s, a consensus of opinion was forming that monetary policy was the instrument best equipped to deal with inflation – which had been a nagging problem in

11 Evidence, The Treasury, 13 March 2000, p.40.
12 Submission 13, The Treasury, p.22.
13 Submission 13, The Treasury, p.22.

the Australian economy. Inflation was, Treasury said, “regarded as an obstacle to sustained economic development.”[14]

3.19 In 1993, reflecting the Government’s wish to reduce Australia’s inflation rate, the Reserve Bank announced that it would aim to keep inflation between 2 and 3 per cent over the course of the economic cycle. Treasury’s submission notes that adopting an inflation target provides direction for monetary policy decisions and adds two related benefits:

- a solid basis for inflationary expectations (reducing speculation); and
- greater certainty in economic decision-making.[15]

3.20 In 1997, in a paper describing inflation targeting, the Reserve Bank explained that there had been a general shift in a range of countries, to the adoption of inflation targeting as a central part of their monetary policy. The Bank outlined the reasons why control of inflation was so widely seen as a necessary goal:

> Medium-term price stability is widely accepted as the appropriate ultimate goal for monetary policy. This reflects two ideas. The first is that high rates of inflation distort decision-making, ultimately leading to slower economic growth. The second is that monetary policy is the most effective instrument in influencing medium-term inflation outcomes. By pursuing a strategy that ensures that inflation does not distort decisions concerning investment, production and savings, monetary policy is best able to contribute to sustainable improvements in living standards.[16]

3.21 The changes in monetary policy were reinforced in 1996 by an agreement between the Treasurer and the Governor of the Reserve Bank, released publicly as a *Statement on the Conduct of Monetary Policy*[17]. The statement formalised the inflation target of 2-3 per cent over the cycle and clearly recognised the independence of the Reserve Bank in setting monetary policy. At this time the arrangement was also established for the Reserve Bank Governor to appear before the House Economics Committee twice a year, to discuss the Bank’s handling of monetary policy. The Bank undertook to release just before each of these hearings, a *Semi-Annual Statement on Monetary Policy* which would form a basis for the discussion at the hearing.

14 Submission 13, The Treasury, p.67.

15 Submission 13, The Treasury, pp.68-9.

16 Reserve Bank of Australia, *Monetary Policy and Inflation Targeting*, Bulletin, October 1997, JS MacMillan, Sydney, p.14. http://www.rba.gov.au/bulletin/bu_oct97/bu_1097_3.pdf

17 *Reserve Bank of Australia, Report and Financial Statements*, Reserve Bank of Australia, Sydney, 30 June 1997, pp. 8-10.

3.22 The Australian economy has shown the benefits of these policy changes in its ability to sustain nine years of continuous growth. Several times in the past, periods of sustained economic growth have been prematurely ended by a rapid increase in inflation. The Reserve Bank said that long sustainable expansions can only be achieved with low inflation levels – where high inflation occurs, the economic expansion does not last.[18]

3.23 To avoid the problem of high inflation, the Reserve Bank has departed from previous practice in the last year, by moving to increase interest rates before inflationary pressures have fully developed, rather than react to a pre-existing problem. This strategy is designed to relieve any inflationary pressure without undermining the growth trend in the economy. To date the strategy has been successful and inflation has been kept within the Reserve Bank's target range – although in the last two or three months there have been concerns that external factors may be pushing the level of inflation up.

3.24 The Committee found that there was concern in recent months over the unexpected weakness of the $A. With the economy still growing quite rapidly and the economic fundamentals still very sound, the Committee said there was no apparent reason for the dollar's dramatic slide to record lows on international exchanges. Most commentators ascribe the problem to the continuing strength of the $US but that does not explain why the $A has also lost ground against a range of other, less dynamic, currencies.

Fiscal policy

3.25 Like monetary policy, Australia's fiscal policy went through a period of uncertainty in the 1970s and 1980s. Treasury's submission referred to a lack of clarity in the fiscal policy framework through that period. It said that at the beginning of the 1990s, this lack of certainty led to the application of a risk premium to debt instruments issued by the Australian Government. This, in turn, affected the risk ratings in the private sector.[19]

3.26 Treasury said in that early part of the 1990s, Australia was dealing with a substantial deterioration in its fiscal position. The problem stemmed from the economy's sluggish recovery from recession and the resultant decline in the budget position.[20]

18 Evidence, Reserve Bank of Australia, p.13.

19 Submission 13, The Treasury, p.68.

20 Submission 13, The Treasury, p.69.

3.27 Concerns over the state of fiscal policy increased when the current account deficit almost doubled. In 1994-5 it stood at almost 6 per cent of GDP. Further concerns arose from an increase in underlying inflation and a widening of the long-term bond rate differential between the US and Australia. Treasury's submission indicated what seemed to be a weakness in the policy framework at this time:

> One shortcoming of the fiscal policy framework over this period was the lack of a clearly articulated framework linking fiscal policy objectives with national saving and current account goals. There was no clear statement of what fiscal policy should be aiming to do over a longer period, and why.[21]

3.28 The outcome was the introduction of a new medium-term fiscal strategy in the 1996-7 budget. The new strategy required an underlying budget balance to be maintained over the course of the economic cycle. An important feature was the decision to retire Commonwealth debt as quickly as possible. This effectively removed Commonwealth borrowings as a contributor to the current account deficit. A *Charter of Budget Honesty* was also introduced[22], requiring the Government to outline its fiscal objectives and to publicly release estimates twice a year and before each election.[23]

Policy performance

3.29 The last fifteen years have seen Australia's monetary and fiscal policies substantially restructured. Internationally those changes have been seen as very successful. The Australian economy's resilience in dealing with the effects of the Asian Crisis drew widespread approval (and not a little envy). When asked whether the Asian Crisis had enhanced Australia's reputation in Asia, ASIC replied:

> Yes, that would be my instinct from the feedback we get, and certainly the desire for them to come here to learn about how to regulate.[24]

3.30 Dr John Edwards offered the opinion that, in adjusting to the pressures of globalisation, Australia has, in some ways, gained more control over its economic policy position. He gave the example of the interaction between monetary policy and the exchange rate. Adoption of a floating exchange

21 Submission 13, The Treasury, p.70.

22 *The Charter of Budget Honesty Act (1998)*, (Commonwealth).

23 Submission 13, The Treasury, p.70.

24 Evidence, Australian Securities and Investments Commission, 22 March 2000, p.63.

rate had, he said, made the exchange rate susceptible to external pressures but had returned control of interest rates to the Government.[25]

3.31 The Department of Finance and Administration (DOFA) suggested that rather than restricting the government's ability to make its own decisions, globalisation has had an effect on the consequences of those decisions. Decisions now have a greater impact, positively or negatively, depending on the reaction of global financial markets to the action undertaken. DOFA said that this "increased the importance of transparency and the like".[26]

3.32 DOFA added that the fiscal reforms undertaken by Australia in recent years have provided a competitive edge in international markets. Any increase in the transparency of fiscal decision making is looked on favourably by global capital markets and, in Australia, "even taxpayers now have a better picture of government expenses and how their moneys are being used", DOFA said.[27]

3.33 The Committee found that, the indications are that Australia's policy stance is well regarded by the international financial markets. As tangible proof of this, the Treasury submission reported that in mid-1999 the ratings organisation Standard and Poors upgraded the Commonwealth's foreign debt issues. The company raised the rating from AA to AA+, the second highest rating, at a time when most of the region was still in financial disarray.[28]

Shared currency

3.34 A number of witnesses raised the question of whether Australia should join in a currency union. It was variously suggested that there could be benefits in associating the Australian dollar with the NZ dollar, or the US dollar, or some regional currency arrangement.

3.35 The Australian Stock Exchange tentatively canvassed the idea that Australia might study the advantages of "dollarisation" i.e. adopting the $US as Australia's currency. This step is already under consideration by a number of countries in South America. It also suggested that if the idea of

25 Evidence, Dr J. Edwards, 22 March 2000, p.99.
26 Evidence, DOFA, 13 March 2000, p.54.
27 Evidence, DOFA, 13 March 2000, p.54.
28 Submission 13, The Treasury, p.71.

an Asian currency, already being studied by ASEAN, comes into being, then Australia could consider joining that currency union.[29]

3.36 The advantage of such a decision, would be to reduce the incidence of currency crises. The disadvantage is, that to join, Australia would have to surrender its independent monetary policy. If Australia were the smaller country involved – as in joining with the $US – it would require the acceptance of the larger country's monetary policy.[30] It would also mean the loss of the revenue derived from seigniorage[31].

3.37 More importantly, it would mean the loss of a very useful way of dealing with relative price differentials between regions – normally absorbed through variations in the exchange rates. If there is a common currency such differentials must be dealt with instead by a myriad of individual price adjustments. For Australia this would be an important factor in favour of retaining an independent currency.[32]

3.38 When asked about the prospect of an Asian currency, the Reserve Bank indicated that this was unlikely to develop. The Governor of the Bank said:

> I cannot conceive that getting off the ground. The countries are so different and there is no political will behind it anyhow, so I do not think there is any likelihood of that at all. … I would put it in the realms of the highly unlikely.[33]

3.39 The Australian Stock Exchange (ASX) in its evidence, agreed that, although it had canvassed the idea in its submission to the inquiry, it was now unlikely that an Asian currency would eventuate. The exchange supported the Reserve Bank's assessment of the situation.[34]

3.40 The Treasury said there was no hard and fast answer on the question of a shared currency but noted that:

> … a currency bloc would demand some fairly extreme convergence of macroeconomic and microeconomic characteristics of the countries concerned. That was certainly the case in Europe and you would be aware of the development of the Maastricht

29 Submission 6, Australian Stock Exchange Limited, p.5.

30 Submission 6, Australian Stock Exchange Limited, p.5.

31 Seigniorage is the difference between the production cost of the currency unit and its face value. It is generated when the public exchanges interest-bearing assets for currency. Submission 6, Australian Stock Exchange Limited, p.5.

32 Submission 6, Australian Stock Exchange Limited, p.5.

33 Evidence, Reserve Bank of Australia, 9 February 2000, p.6.

34 Evidence, Australian Stock Exchange, 9 February 2000, p.17.

> criteria in Europe that were designed to achieve economic convergence before economic monetary union commenced. Those conditions were reasonably uncompromising, although I must say … I wonder even now if they were sufficiently strict, and in any group of countries that you are looking at and speculating as to whether they were a candidate for a currency bloc, conditions of that sort would have to be satisfied.[35]

3.41 One of the main reasons advanced for the concept of a shared currency was to reduce the incidence of contagion between crisis prone countries. The Treasury, however, took different view:

> … there is a question of whether the development of a currency bloc actually insulates a country from contagion. I think what it would probably do is just ensure that the contagion is automatic. If market players take a particular view on a country or on a bloc of countries and that affects the currency, then it would just automatically affect the currency of that trading bloc.[36]

3.42 Treasury's opinion was that different exchange rate regimes might suit different countries at different times. It did not seem necessary, Treasury said, that the regime should be one of the extremes of the spectrum – a floating exchange rate or a completely fixed exchange rate. Treasury was of the opinion other exchange rate regimes can be sustained for long periods of time and that the important thing is:

> … not the exchange rate regime but the macroeconomic and microeconomic policies that the country is running and, as well, the institutional framework that that economy has.[37]

3.43 There has also been considerable media speculation recently about the idea of a joint Australian-NZ currency – an ANZAC dollar. This idea was previously raised at one of the Reserve Bank's biannual appearances before this Committee. The Bank's response was that since the costs and benefits of such a change fall to the smaller country involved, Australia is leaving the running on this issue to New Zealand.[38] The Committee is not convinced that Australia would benefit from a regional currency union, however, that would not preclude NZ pegging its currency to the $A.

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35 Evidence, The Treasury, 13 March 2000, p.48.

36 Evidence, The Treasury, 13 March 2000, p.48.

37 Evidence, The Treasury, 13 March 2000, p.48.

38 House of Representatives Standing Committee on Economics, Finance and Public Administration, *Review of the Reserve Bank of Australia Annual Report 1998-99*, June 2000, CanPrint Communications, Canberra, p.25 and evidence to that inquiry, Reserve Bank of Australia, 22 May 2000, pp.80-81.

3.44 Nevertheless, there is a need for Australian policy makers to closely monitor the European experience with the introduction of the Euro; the most significant recent example of currency convergence in the world.

Strategies against market volatility

3.45 Market volatility was at the heart of the Asian Crisis. The build-up in several countries of short term speculative capital, unhedged against changes in the market, allowed the massive retreat of overseas funding which drove the crisis.

3.46 The Committee said that it was noticeable that countries where a greater proportion of overseas funding had been in the form of long-term investment in capital projects, for example Malaysia, were less severely affected by the crisis.[39]

3.47 The other weakness which quickly led the crisis countries into difficulty, was the attempt to maintain fixed or partially fixed exchange rates. The Reserve Bank has credited the floating Australian exchange rate with the major role in maintaining Australia's ability to avoid contagion during the crisis.

3.48 To maintain a fixed exchange rate in the conditions leading up to the Asian Crisis required great resolve on the part of central bankers and enormous reserves of foreign exchange. In the end, the worst affected countries proved to have too little of both.

3.49 The importance of sound economic policies in dealing with a volatile market cannot be overstated. Dr Edwards in his evidence, pointed out that at the beginning of the crisis, Australia shared many points of similarity with the crisis countries: a current account deficit of similar size to Korea's, foreign debt of about the same size and maturity as Korea's and a level of foreign reserves lower than Indonesia's. Yet Australia was relatively unscathed while the crisis countries were financially devastated.[40]

3.50 Dr Edwards placed great weight on the benefits derived by the Australian economy from the reforms of the past 15 years:

> The intent of the bulk of those [changes] was to increase our openness to the global economy, and we have benefited hugely

39 Evidence, Dr J.Edwards, 22 March 2000, p.102.

40 Evidence, Dr J. Edwards, 22 March 2000, p.96.

> from those reforms – in particular, tariff cuts, float of the currency and deregulation of financial markets – as much from opening ourselves to the world as from changes we have been able to make internally, such as deregulation of the labour market and improvements to our taxation system.[41]

3.51 The Reserve Bank in its evidence, assigned the greatest importance to the floating exchange rate[42]. However, it also recognised the importance of the structural changes to Australian financial markets in resisting the effects of the Asian Crisis. The RBA suggested that a comprehensive risk management strategy requires great depth in financial markets, to permit the government to avoid reliance on short-term funding and to reduce the impact of sudden changes in the market. Australia, the RBA said, now has that depth and the Government is able to borrow for long periods (10-13 years), in $A, from both Australian citizens and foreign lenders. During the crisis this facility considerably reduced Australia's exposure to currency fluctuations.[43]

3.52 The other key factor in resisting market volatility is the ability to control inflation. Australia has been operating at low levels of inflation now for several years and was able to avoid excessive inflationary pressures during the crisis. If inflation is allowed to push up internal interest rates, it becomes difficult to restrain offshore borrowing – this was the problem faced by a number of the Asian crisis countries. Funds flowed in from low interest rate areas such as the US and Europe, whose investors were only too happy to take advantage of the demand created by the rapid increases in Asian interest rates. Asian borrowers appreciated the access to lower interest rates but were helpless when the flood of funds began to reverse itself.

3.53 Allied to these aspects of the risk management process is the need for the system to be as transparent as possible and for a comprehensive regulatory and prudential system to be in place. With the reforms to these aspects of the Australian system in recent years, Australia is widely regarded as close to world's best practice in each of these crucial areas.[44] Likewise, as previously mentioned, the stability of the democratic government system is of paramount importance.

41 Evidence, Dr J. Edwards, 22 March 2000, p.95.

42 Evidence, Reserve Bank of Australia, 9 February 2000, pp.5-6.

43 Evidence, Reserve Bank of Australia, 9 February 2000, pp.5-6.

44 Submission 13, The Treasury, pp.26-8 & 30.

Electronic commerce and transfer pricing

3.54 Another significant issue is the growth of electronic commerce, especially the difficulty of correctly taxing electronic transactions. In that context discussion centres on the concept of "transfer pricing". In a report in 1998, the Joint Committee of Public Accounts and Audit (JCPAA), quoting from an OECD paper, wrote:

> Transfer prices are significant for both taxpayers and administrations because they determine in large part the income and expenses, and therefore taxable profits, of associated enterprises in different tax jurisdictions.[45]

3.55 Transfer pricing is a form of international tax avoidance. It refers to a practice mainly employed by trans-national companies to shift the main burden of taxation on their profits to the office located in the country with the lowest tax regime. The practice can be effective for related members of a corporate group and for different branches or divisions of the same corporation. At times third party arrangements with unrelated companies are also employed.

3.56 Transfer pricing is applied by the parties agreeing on artificial prices, payments or other terms, to alter the amount of tax which would have been payable if the parties were independent. To counter the practice taxation authorities apply the "arm's length principle", that is to determine the price which would have been paid in the transaction if it had been between independent companies. The aim is simply to ensure that Australia can collect its fair share of the tax due. The JCPAA referred to the methodologies set out in *The Australian Master Tax Guide*:

> There are a number of internationally accepted arm's length methodologies, all of which are based on the concept of comparability – comparing the prices/margins achieved by associated enterprises in their dealings with each other to those achieved by independent enterprises for the same or similar dealings. Taxpayers should utilise the method which produces the highest practicable degree of comparability. The standard of comparability that is practicable will be determined by how much reliable data is available to make comparisons with uncontrolled situations.[46]

45 Joint Committee of Public Accounts and Audit, *Internet Commerce: To buy or not to buy?*, Report 360, AGPS, CanPrint Communications, Canberra, May 1998, p.70.

46 Joint Committee of Public Accounts and Audit, *Internet Commerce: To buy or not to buy?*, Report 360, AGPS, CanPrint Communications, Canberra, May 1998, p.70.

3.57 Treasury said that the Australian Taxation Office (ATO) had been concentrating on reducing the problem in Australia. At the time of the hearing, there were cases under review involving expected tax adjustments of more than $400 million. In one area already audited, the ATO representative reported a 90 per cent increase in reported taxable incomes. He reported that 70 major audits were in progress.[47]

3.58 More generally on e-commerce, the Committee was concerned that the growing use of Internet transactions would make tax assessment more difficult? It asked how could the Taxation Office determine when taxes such as the GST were due and how much was payable? Treasury reported that these were not issues specifically related to e-commerce. The problem had been around for a long time – all that e-commerce changed was the speed and the number of transactions.[48] The JCPAA, however, found that generally, the international community was expecting the problems to grow both in frequency and complexity.[49]

3.59 Treasury noted that when something was purchased over the Internet, there would be a record of the payment – e.g. with one of the credit card organisations – and the Taxation Office has access to those financial records. Treasury reported that there was a considerable amount of work going on in technical working groups of the Organisation for Economic Cooperation and Development (OECD) on these issues and it is hoped that the results of that work will have world-wide application.[50]

3.60 For small transactions, there remained the problem of balancing administrative costs with the revenue to be collected. Customs, for example, has an insubstantial value provision and does not collect import duty on minor purchases where the value of the purchase is insubstantial or where the revenue would not cover the cost of collection ($50 is the benchmark).[51] A similar provision was used to waive any sales tax due.[52]

3.61 Treasury said that there was no suggestion at this stage that existing taxation systems could not cope. In the long-term, however, Treasury expected that national taxation regimes would be backed up by a comprehensive international exchange of information and that there

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47 Evidence, The Treasury, 13 April 2000, p.121.

48 Evidence, The Treasury, 13 April 2000, p.125.

49 Joint Committee of Public Accounts and Audit, *Internet Commerce: To buy or not to buy?*, Report 360, AGPS, CanPrint Communications, Canberra, May 1998, pp.70-1.

50 Evidence, The Treasury, 13 April 2000, p.126.

51 Evidence, The Treasury, 13 April 2000, pp.123-5.

52 Joint Committee of Public Accounts and Audit, *Internet Commerce: To buy or not to buy?*, Report 360, AGPS, CanPrint Communications, Canberra, May 1998, pp.110-1.

would be much greater uniformity in taxation rates on both income and consumption. The example was given of the OECD's attempts to have its members jointly identify tax havens and apply penalties to transactions with those places.[53]

3.62 However, given that tax regimes can be used to provide a competitive advantage, e.g. as in recent years in Ireland, the Committee does not share Treasury's expectations regarding uniformity of tax regimes. The Committee recommends that a major study be undertaken to explore the impact of these taxation regimes, particularly in the light of our recent reforms.

Australia as a regional finance centre

3.63 The Committee was interested in the Government's decision to work towards making Australia an international financial centre for the region. It noted that the Minister for Financial Services and Regulation, the Hon Joe Hockey, had enumerated the advantages that Australia has to offer as a financial centre:

- political stability;
- deep and liquid financial markets;
- a strong and growing domestic economy;
- a highly educated, multi-skilled and multi-lingual workforce;
- world class infrastructure;
- a world class regulatory framework; and
- a working day that spans the time zone from the close of business in the US to the opening of business in Europe.[54]

3.64 Mr Hockey also outlined specific programs designed to attract investment in modern, high growth industries. Prominent among these is Invest Australia, a national agency which facilitates major investment projects and provides a range of services to companies establishing operations in Australia. Similarly, the Regional Headquarters Program encourages companies to make Australia their servicing base for the Asia-Pacific region. The program offers tax incentives and offers assistance in other

53 Evidence, The Treasury, 13 April 2000, pp.127-8.

54 Hon Joe Hockey, *Australia as a centre for global financial services*, Speech, New York, 14 July 1999, pp.1-2, 4. http://www.minfsr.treasury.gov.au/speeches/1999/018.asp

areas, such as immigration arrangements for executives of the company. The Minister has also indicated that Australia has an advantage[55]

3.65 In this context, the recent series of decisions to increase interest rates had sparked media speculation that the advantages offered by Australia would be eroded. The Governor of the Reserve Bank refuted suggestions that the interest rate increases would make Australia a less attractive place for the development of a financial centre, and commented:

> I certainly do not agree with that assessment … It seems to me that the thing that we can do directly to make Australia an attractive place for people to do business in is to have a good economic performance and the main test of that would be further long, sustainable economic expansion. The rise in interest rates, we believe, will contribute to that and that is the major thing we can do.[56]

3.66 Raising interest rates to maintain the stability of the system should, the RBA said, be considered sound economic policy:

> Personally, I cannot see a mechanism whereby raising interest rates in a responsible manner, as has been done here and has been done in a number of other countries – major financial centres like the US and the UK – could in any way be construed as being detrimental to their growth as financial centres.[57]

3.67 Referring again to the interest rate increases and whether they would be an issue that might harm Australia's case with investors, the RBA said:

> It certainly is not an issue. In fact, I think that if we had tried to defy gravity, it might have been harmful. But by doing the sensible thing, I do not think it has done any harm at all.[58]

3.68 Dr Carolyn Currie commented that Australia needed to undertake some taxation changes to make itself competitive with cities such as Hong Kong:

> The whole point about Australia as a financial centre is that we want the financial centre to migrate here. For that to happen we have to do a few things, which is equalise our tax with the

55 Hon Joe Hockey, *Australia's Place in the Asian Financial Landscape*, Speech to Credit Suisse First Boston Asian Investment Conference, Hong Kong, 24-26 March 1999, p.5. http://www.minfsr.treasury.gov.au/speeches/1999/009.asp

56 Evidence, Reserve Bank of Australia, 9 February 2000, p.3.

57 Evidence, Reserve Bank of Australia, 9 February 2000, p.3.

58 Evidence, Reserve Bank of Australia, 9 February 2000, p.3.

> regimes, equalise the incentives offered to relocate here and equalise our visa and air fares.[59]

3.69 On this topic of taxation regimes, the Australian Stock Exchange suggested that there are some impediments to the idea of attracting a financial centre to Australia, mainly in the form of taxes. ASX added that recent taxation decisions had improved Australia's competitive position – changes to capital gains tax, a range of State taxes being scheduled for removal and the planned abolition of the stamp duty on share trading on 1 July 2001:

> The whole tax reform push has been a great plus, and the new efforts, with the appointment of Les Hosking as the head of a centre for global financial services, is certainly going to be a very important part of promoting Australia. Getting Australia on the radar is not always easy. … when you are 1.2 per cent of world … capital it is not always easy to get yourself on the radar of the decision-makers.[60]

3.70 Mr Hockey addressed the question of the Australian tax regime in a speech in New York. He explained that Australia's tax reform legislation included a number of features which would enhance Australia's attraction as a financial centre. As examples, he referred to the removal of some inefficient financial services taxes, relaxed taxation provisions for mutual fund investors and an overhaul of Australia's treatment of Offshore Banking Units.[61]

3.71 ASX advised the Committee that scale and volume of business were all important in the global markets:

> One of the reasons we were seeking to merge with the SFE was in fact to have that scale for Australian exchanges to be a more significant player on the world stage. A lot of our efforts will continue to have to go into lifting this scale of Australia's operations.[62]

59 Evidence Dr Carolyn Currie, 9 February 2000, p.31.

60 Evidence, Australian Stock Exchange, 9 February 2000, p.21.

61 Hon Joe Hockey, *Australia as a centre for global financial services*, Speech, New York, 14 July 1999, p.3. http://www.minfsr.treasury.gov.au/speeches/1999/018.asp

62 Evidence, Australian Stock Exchange, 9 February 2000, p.21.

Table 1: Value of Share Trading ($US million)

Country	1998	1999	% Change 1999/98
Australia	161,001	198,195	23.1
Hong Kong	206,153	230,032	11.6
Singapore	58,510	107,407	83.6

Source International Federation of Stock Exchanges, Paris, Table 1.4B http://www.fibv.com/

3.72 The DFAT EAAU noted that the strength of Australia's prudential framework and financial markets enhance its attractiveness as a regional financial centre. The EAAU also commented:

> In 1998, to promote Australia's regional financial centre role and initiate policy reforms to enhance this objective, the Government appointed a Minister for Financial Services and Regulation.[63]

3.73 The Committee observed that when the likely scale of operations for such an international finance centre is considered, it raises a problem that Australia must urgently address; that is ensuring that sufficient specialists are available to fill all of the skilled jobs which would be generated. It has been estimated that a major bank would need five thousand of such specialists to relocate its finance centre to Australia – including IT specialists, lawyers, accountants, etc.

3.74 To offset this difficulty, of course, Australia offers benefits that are not to be found anywhere else in the region – low cost operations, high quality workforce, political stability and quality of life – the Committee added.

3.75 The EAAU summed up Australia's case as follows:

> The Australian economy and financial sectors performed strongly during the financial crisis, partly because over the past two decades, Australia has reformed prudential controls and liberalised its financial market. These moves strengthen Australia's position as a regional and global financial centre, as do skilled, competitively priced financial market human resources. Recent taxation reforms enhance this competitiveness; consequently major foreign financial institutions including Citibank, Deutsche Bank and Hong Kong Shanghai Bank are relocating regional functions to Australia.[64]

63 East Asia Analytical Unit, *Asia's Financial Markets: Capitalising on Reform*, Department of Foreign Affairs and Trade, Canberra, 1999, p.344.

64 East Asia Analytical Unit, *Asia's Financial Markets: Capitalising on Reform*, Department of Foreign Affairs and Trade, Canberra, 1999, p.12.

Recommendation 2

3.76 **The Committee recommends that the Government:**

- **continue to recognise the need to determine how employees and small businessmen displaced by the globalisation process can be assisted to make the transition to new employment;**
- **continue to explain what steps are being taken to reduce Australia's current account deficit;**
- **carry out additional work on public discussion and the dissemination of information on the changes occurring in international financial markets;**
- **determine whether additional measures are required to ensure that Australia does not experience a build-up of short-term foreign debt; and**
- **determine what additional steps are needed to ensure that companies moving financial centres to Australia are able to employ the necessary specialists to staff those centres.**

Recommendation 3

3.77 **The Committee recommends that a major study be undertaken to explore the impact of various taxation regimes in our major trading partners. The study should assess these regimes in the light of recent reforms to the Australian tax system.**