

Chapter 11

Taxation and labour and capital flows



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11. TAXATION AND LABOUR AND CAPITAL FLOWS

SUMMARY

While the taxation regime can be an important factor at the margin in shaping the economic decisions of individuals and companies on where to work and invest, it is only one of a wide range of complex considerations which influence such choices.

Of the top 10 countries/regions which high-skilled persons in Australia depart to, Australia experiences positive net migration of high-skilled persons from all except for Hong Kong (Special Administrative Region (SAR) of China), where the net loss is small. As all these countries/regions have all-in top marginal tax rates lower than Australia's, it would appear that there are many drivers as to why high-skilled people migrate to Australia.

With respect to foreign investment and particularly foreign direct investment (FDI), again a whole range of factors, not just tax, come into play. Australia has a corporate tax rate less than or broadly equal to four out of five of its top FDI contributors, the top three of which have comprehensive foreign tax credit (FTC) systems.

11.1 INTRODUCTION

In an increasingly integrated global economy, with mobile labour and capital, a number of factors influence the economic decisions of individuals and companies on where to work and invest. For companies, these factors may include: macroeconomic stability; resource endowments; workforce skills; quality of infrastructure; effective economic and political institutions; efficient, open and appropriately regulated financial, product and labour markets; openness to new technology; and an entrepreneurial culture. For individuals, these factors could include: potential gross earning opportunities; the cost of living; the availability of education and health services; leisure opportunities; environmental amenity; and lifestyle preferences. A country's tax regime can be an important factor at the margin in influencing the economic decisions of companies and individuals. But tax is only one of a wide range of complex considerations which influence such decisions and should not be singled out as the most important factor affecting these choices.

This chapter broadly looks at the labour and capital flows between Australia and the rest of the world and what impact (if any) the tax system may be having on these outcomes. The chapter concludes with information on Ireland and the emerging major markets of China and India (see Boxes 11.1, 11.2 and 11.3).

11.2 LABOUR FLOWS

There is a concern that Australia's tax system might be encouraging high-skilled persons to leave Australia and discouraging high-skilled persons from coming, or returning, to Australia. This section looks at Australia's high-skilled migration patterns over recent years and whether differences between Australia's and other countries'/regions' all-in top marginal tax rates possibly relate to them. Other measures of differences in tax systems were considered (for instance, the tax wedge discussed in Chapter 4), but generally comprehensive comparable data was not available.

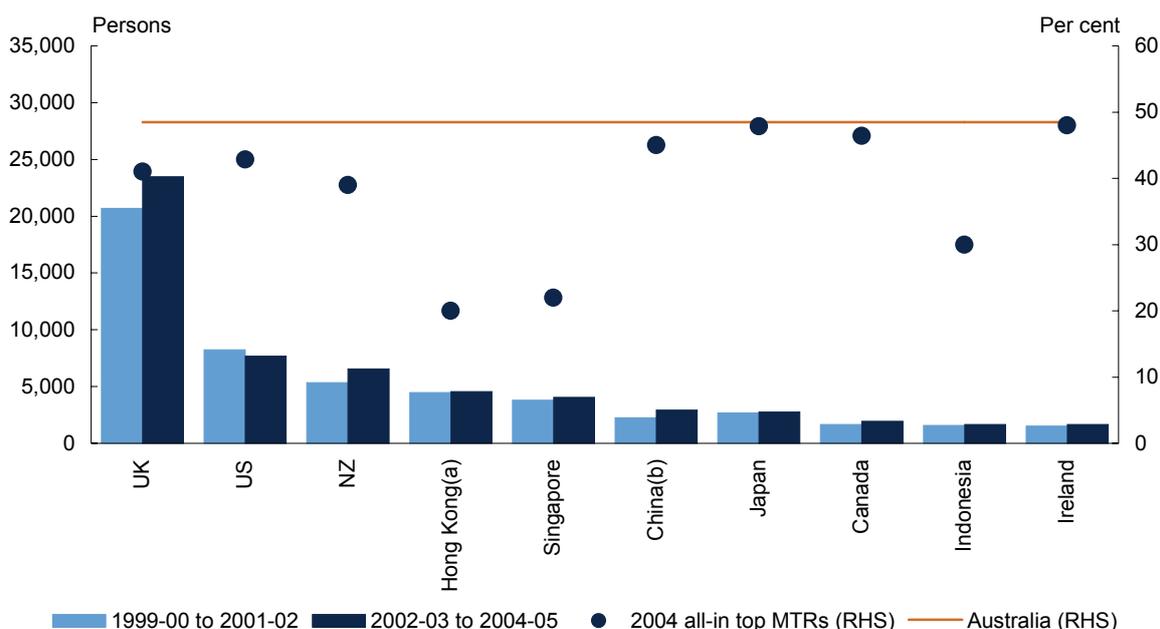
- High-skilled persons are defined as persons stating an occupation that is in the two highest skilled occupational groups in the Australian Standard Classification of Occupations (second edition): Managers and Administrators, and Professionals. Following Birrell et al (2005), persons identifying as self-employed persons are counted as Managers and Administrators.

11.2.1 High-skilled migration

Chart 11.1 shows permanent and long-term departures of high-skilled persons from Australia by country/region of next residence, with average yearly departures in the three-year periods to 2001-02 and 2004-05 compared with all-in top marginal tax rates in destination countries/regions. The countries/regions in the chart are the 10 largest recipients of permanent and long-term departures of high-skilled persons from Australia over the three years to 2004-05. The chart shows a stable pattern of high-skilled departures in recent years, with the United Kingdom dominating other countries/regions as the main destination.

Chart 11.1: Permanent and long-term departures of high-skilled persons from Australia

15 years and over, by country/region of next residence, three-year averages



(a) Special Administrative Region (SAR).

(b) Mainland.

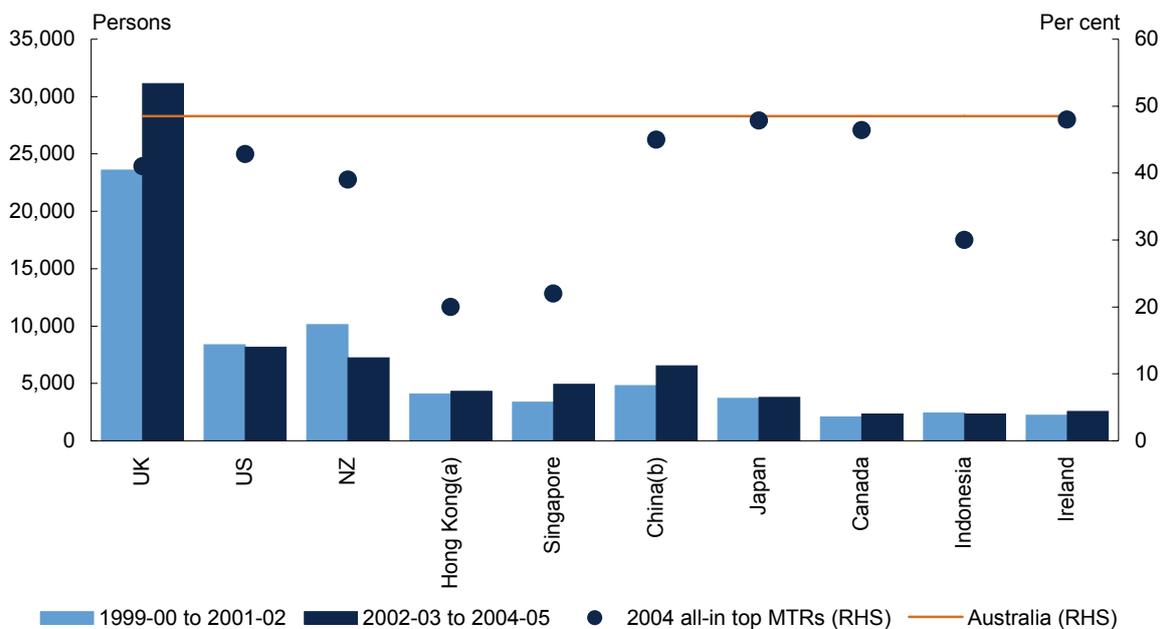
Source: Treasury calculations based on Department of Immigration and Multicultural Affairs data.

Note: Total high-skilled persons include both Australian residents and long-term visitors (long-term temporary residents).

Departures of high-skilled persons from Australia should be seen in the context of an Australian high-skilled workforce of over 2.5 million employed persons and substantial arrivals of high-skilled persons from overseas. The large number of arrivals is related to Australia's skilled migration programme and a high return rate for Australian residents departing Australia on a permanent or long-term basis (Birrell et al 2005). Also, high-skilled Australians living overseas, and the presence of high-skilled migrants in Australia, may provide benefits in terms of better access to foreign markets and trade and investment links back to Australia.

As discussed, departures of high-skilled persons from Australia are offset by high-skilled Australian residents returning from overseas and arrivals of high-skilled settlers and long-term temporary residents. Chart 11.2 shows permanent and long-term arrivals of high-skilled persons to Australia by country/region of last residence, with average yearly arrivals over the three-year periods to 2001-02 and 2004-05 compared with all-in top marginal tax rates.

Chart 11.2: Permanent and long-term arrivals of high-skilled persons to Australia
15 years and over, by country/region of last residence, three-year averages



(a) Special Administrative Region (SAR).

(b) Mainland.

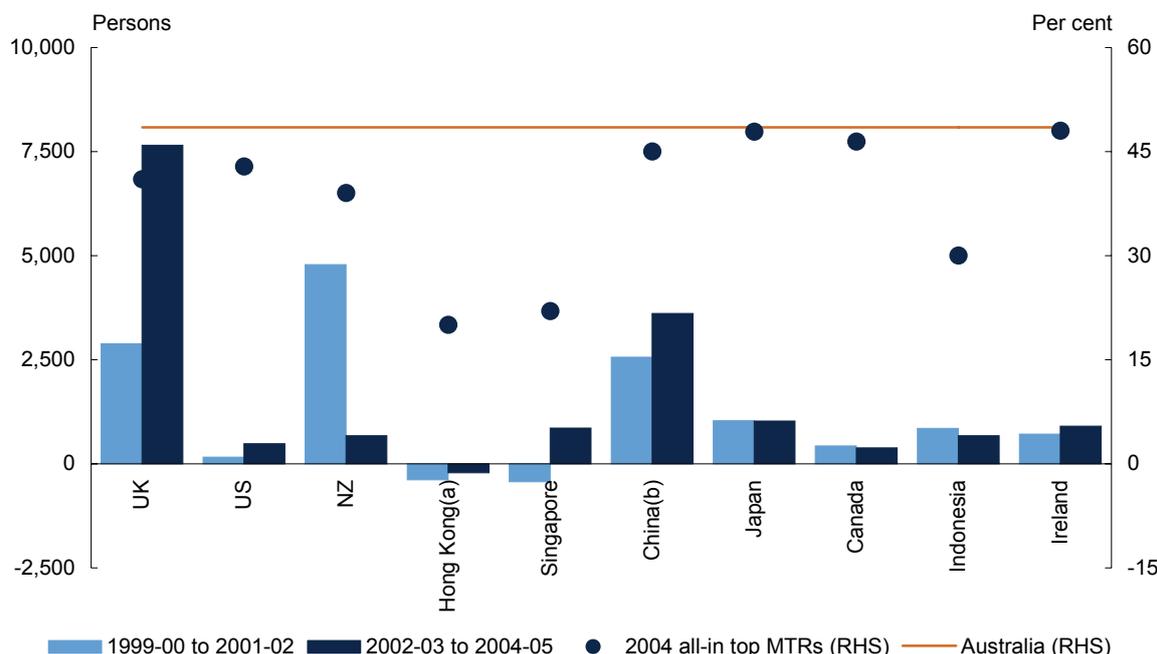
Source: Treasury calculations based on Department of Immigration and Multicultural Affairs data.

Note: Total high-skilled persons include settlers, Australian residents, and long-term visitors (long-term temporary residents).

In the aggregate, high-skilled arrivals exceed departures and Australia has a net brain gain from international migration. In the three years to 2004-05, there was an average yearly net contribution to total high-skilled workers in Australia of around 33,000 persons, which has increased significantly since the three years to 2001-02 when the average yearly net contribution was around 24,000 persons. Chart 11.3 shows net permanent and long-term migration of high-skilled persons compared with the all-in top marginal tax rates in the country/region of last or next residence.

Chart 11.3: Net permanent and long-term migration of high-skilled persons into Australia

15 years and over, by country/region of last/next residence, three-year averages



(a) Special Administrative Region (SAR).

(b) Mainland.

Source: Treasury calculations based on Department of Immigration and Multicultural Affairs data.

Note: Net permanent and long-term migration represents the net migration of settlers, Australian residents, and long-term temporary residents.

Of the top 10 countries/regions which high-skilled persons in Australia depart to, Australia experiences positive net migration of high-skilled persons from all except for Hong Kong SAR, where the net loss is small. All these countries/regions have all-in top marginal tax rates lower than Australia's, therefore suggesting there is likely to be a range of factors that individuals consider important, including after-tax wages, adjusted for the cost of living in different countries/regions, cultural ties, the quality of leisure, the availability of education and health services, language differences, environmental amenity, safety, and visa requirements.

A caveat to this analysis is that it assumes workers stating a particular occupation are of equal quality. But quality differences between arrivals and departures of high-skilled persons would have to be significant to detract from the conclusion that Australia is a net gainer of high-skilled labour from international migration.

Another caveat is that the aggregate data mask net losses for particular occupations, although there appear to be net losses for only a small number of high-skilled occupations. Most significantly, in the three years to 2004-05, there were average yearly net losses of around 150 legal professionals and around 360 air transport professionals, including both pilots and air traffic controllers. These net losses are likely to be related to the available opportunities and relatively high incomes that persons in these occupations can earn in other countries/regions.

11.3 CAPITAL FLOWS

This section examines the size and breakdown of investment flows between Australia and the rest of the world, and then considers how Australia's taxation arrangements might influence the investment decisions of multinational corporations.

11.3.1 Australia's international investment position

Australia is a net recipient of capital from the rest of the world, and has been in this position for almost its entire history. Reflecting this, Australia continues to record net income outflows to the rest of the world.

As at 31 December 2004 (latest year for country-by-country breakdowns of Australian FDI):

- Australia recorded a net international investment position of \$505 billion, of which \$422 billion was net foreign debt and \$83 billion was net foreign equity;
- total foreign investment in Australia was \$1,155 billion, of which \$487 billion was equity investment (of which \$298 billion was FDI and \$188 billion was portfolio);¹ and
- total Australian investment abroad was \$650 billion, of which \$404 billion was equity investment (of which \$256 billion was FDI and \$148 billion was portfolio).

Over 40 per cent of Australia's *inbound* foreign investment stock was equity, of which over 60 per cent was FDI.²

By end-2004, the leading investor countries/regions in Australia were the United States (32 per cent of *total foreign* investment stock in Australia), the United Kingdom (24 per cent), Japan (4 per cent), and the Netherlands, Hong Kong SAR, New Zealand and Switzerland (each with around 2 per cent).

- For only FDI into Australia, the order was similar, being the United States (49 per cent of total FDI), the United Kingdom (12 per cent), Japan (5 per cent), the Netherlands (5 per cent) and Switzerland (3 per cent) – see Table 11.1.

By end-2004, the leading countries/regions in which Australia invested were the United States (45 per cent of total Australian investment stock abroad), followed by the United Kingdom (17 per cent), New Zealand (6 per cent), Japan (4 per cent) and the Netherlands (3 per cent).

- For only FDI out of Australia, the order was similar, being the United States (55 per cent of total FDI), the United Kingdom (18 per cent), New Zealand (9 per cent), Cayman Islands (4 per cent) and the Netherlands (2 per cent) – see also Table 11.1.

1 For the purposes of this chapter, direct equity investment in Australia is taken to be Australian inbound FDI. (Numbers may not add due to rounding.)

2 Over 60 per cent of Australia's *outbound* foreign investment stock is equity, of which over 60 per cent is FDI. Australia runs similar net investment balances on FDI and portfolio equity (just over \$40 billion each).

Australia is attracting significant foreign investment, including FDI and portfolio equity investment. At the aggregate level, it is not clear what impact tax may be having.

11.3.2 Location considerations

Greater economic integration and increased levels of direct investment create opportunities and challenges for businesses operating in the world economy. Some companies with substantial offshore investments have had to decide, for example, whether they can compete successfully while retaining their head office in the home country and how best to access domestic and global capital markets.

Companies now face greater choices in meeting these challenges. Choices exist over the place of residence of the parent company and its subsidiaries, over the location of global and regional head offices and related headquarter functions, and over stock exchange listings. Often the location of these functions may be split between more than one country.

A number of factors can affect the investment decisions (including location and scale) made by domestic and international companies. Tax is only one of a long list of potential factors, such as market proximity, quality of infrastructure, location of other like firms in an industry, presence of related industries, labour force skills and productivity, and political and economic stability. For tax to have an impact on the location decision between countries, the choice between possible locations based on all the other non-tax factors would need to be quite a close one.

11.3.3 Statutory corporate tax rate effect

Community discussions on Australia's tax system and capital flows is often based around the corporate tax rate. This measure is the focus for the discussion below.

Comparing statutory corporate tax rates has its limitations in assessing Australia's corporate tax burden and attractiveness as an investment location. Nevertheless, the corporate tax rate can have headline significance for a multinational corporation trying to decide where to locate a profitable investment project, and for global capital flows in general. (See discussion on effective average and marginal tax rates in Chapter 5.)

Statutory rates can also be important for companies able to engage in profit-shifting through having related foreign parties in lower-tax jurisdictions. Profit-shifting through transfer pricing, thinly capitalising or shifting passive assets and income can reduce the global tax incurred by the group.

- In cases where Australian subsidiaries of foreign parents have significant Australian shareholdings, Australia's imputation system may to some extent encourage profits to be earned and taxed in Australia instead of in a foreign jurisdiction.

Australia's attractiveness as a destination for FDI can be looked at in at least two dimensions. First, whether Australia is attractive as a destination for FDI relative to a foreign company undertaking a similar investment in their *home* country. Secondly, once this threshold has been met, whether Australia is attractive as a destination for FDI relative to a foreign

company undertaking a similar investment in another host (third) country – a country competing for similar FDI.

11.3.4 Impacts of a home country's treatment of foreign income

Tax factors for the marginal investment (assuming non-tax factors are neutral – a strong assumption) include the corporate tax rate differential between the potential host country (Australia) and the home country, as well as the home country's treatment of company foreign income.

Where the host country (Australia's) corporate tax rate is lower, the tax advantage for FDI may be neutralised if the home country has a FTC system.

- Abstracting from attribution rules (discussed in Chapter 10), home country FTC systems typically tax foreign income when repatriated. A tax credit is usually given for foreign tax paid up to the home country tax payable on the foreign income (called the FTC limit or cap). Where foreign tax rates are below the FTC cap, which may be based on the income tax rates applied by national and sub-national governments, home country tax is applied which neutralises the host country's tax advantage.
- A tax advantage for the host country may re-emerge if there is a timing difference between the host and home country taxing points (that is, where repatriation of the foreign income is deferred).

Where the home country provides an exemption for company foreign income (instead of a FTC system), the advantage of the host country having a lower corporate tax rate remains.

- Moreover, with an exemption, home country tax may be deferred even longer, adding further to the host country's advantage.

The potential advantages from a lower corporate tax rate and tax timing differences on inducing FDI is further complicated by the home country's shareholder relief system (for example, imputation, exemption, uniform dividend credit) and the degree to which the resident company in the home country has foreign shareholders (and conduit taxation relief).

11.3.5 Impact of a competitor country's corporate tax rate (and base)

This section considers whether Australia's corporate tax rate is attractive relative to its competitor countries for similar FDI (assuming non-tax factors are equivalent).

For example, resource-rich countries such as Brazil and South Africa may be competing with Australia for the same FDI dollar. Labour-rich countries such as China and India (albeit with tighter foreign capital/ownership controls) may be competing with each other rather than Australia for the labour-intensive manufacturing FDI dollar.

- Brazil has a corporate tax rate of 34 per cent (including the surtax and social contribution tax), which exceeds Australia's. India and China also have higher statutory corporate tax rates than Australia – see Boxes 11.2 and 11.3.

Where competitor countries differ in their tax rates *and bases*, more analysis is required. As discussed in Chapter 5, effective average and marginal tax rate measures are used to assess the value of investments where differences in tax bases also exist.

To be an attractive place for FDI, Australia has to be more attractive to foreign investors than similar investments in the investor's home country. (This aspect is explored further below.) Australia also has to be more attractive than its third country competitors for similar FDI. As discussed in 11.3.2, tax is just one of many possible factors that determine the attractiveness of a location for investment.

11.3.6 Australia's key sources of FDI and their tax systems

Table 11.1 shows the corporate tax rates of those countries which contribute the five highest levels of FDI (direct equity) into Australia.

Table 11.1: Australia's FDI (direct equity) levels, 2004

Country	Share of total FDI in Australia (per cent)	Corporate tax rate(a)
United States	48.6	39.3
United Kingdom	11.9	30.0
Japan	5.3	40.7
Netherlands	5.1	29.6
Switzerland	3.1	21.3
	73.9	

(a) Rates as at 1 January 2006, except for the United States, which is the OECD 2005 full statutory corporate tax rate estimate. These rates include surtaxes and sub-national taxes on corporate income. Surtaxes and sub-national taxes often apply to corporate domestic and foreign income and help determine the FTC cap. The United States, the United Kingdom and Japan use a comprehensive FTC system for taxing the income of offshore subsidiaries and branches.

Source: ABS (2004); OECD Tax Database; and various country websites.

These five countries account for around 74 per cent of Australia's inbound FDI. Australia's 30 per cent corporate tax rate is less than, or broadly equal to, four out of the five countries in Table 11.1. Also, Australia's top three sources of FDI (the United States, the United Kingdom and Japan) all use a comprehensive FTC system for taxing the foreign source income of their companies.

Box 11.1: Have Ireland's low tax rates been responsible for its economic success?

Ireland experienced a rapid transformation in the 1990s, growing, on average, at 9 per cent annually between 1994 and 2000. Ireland's economic success, during this period and subsequently, has been due to its pursuit of sound economic policies (which allowed the country to integrate into Europe and the global economy), the global economic boom in the second half of the 1990s, and generous assistance from the European Union (EU).

Ireland's policy priorities included the removal of barriers to trade and investment, a shift to macroeconomic and fiscal stability, structural reform, encouragement of immigration, and low corporate tax rates. The openness of the Irish economy has enabled it to take a significant share of global FDI flows into the EU. While Ireland has had generally low tax rates, this was just one factor among many contributing to its strong economic performance.

Ireland joined the European Economic Community in 1973, leading to the removal of barriers to trade with Europe during the mid-1970s. This reduced Ireland's economic isolation and created an impetus for the general opening of its economy. Further, structural funding from the EU averaged 1.5 per cent of gross national income (GNI) during the 1980s and 2.6 per cent of GNI in the 1990s (McCarthy 2001).

After running large budget deficits through the mid-1980s, Ireland's fiscal position was stabilised through efforts to reduce expenditure on social initiatives, public capital investment and public sector employment. Between 1988 and 1993, as Ireland prepared to enter into the Exchange Rate Mechanism, exchange controls were progressively relaxed and capital controls dismantled, leading to a fall in interest rates and an increase in demand for credit. From 1993, foreign investors faced lower exchange rate risk in Ireland.

Since 1987, a series of agreements between government, unions and employers have moderated wages growth. These agreements have also lowered personal income tax rates, reducing the wedge between labour costs and personal incomes.

Immigration substantially increased in the 1990s. In 2004, the total Irish population was estimated at just above 4 million, the highest figure since 1871 after being just 2.8 million in 1961. The inward migration flows were an important factor in containing Irish wage costs in the late 1990s when employment growth was strong and the labour market tight. A surge in inward migration of migrants with relatively advanced educational qualifications has also increased the growth potential of the economy.

Ireland's low taxation levels are sometimes identified as a key factor in its economic success. For example, a 10 per cent preferential corporate profit tax (CPT) rate had long been applied to profits from manufacturing and internationally traded services. While it is true that Ireland's tax burden is less than the OECD average, there was no dramatic change in tax rates or in the structure of the tax system during the boom period in the second half of the 1990s. Ireland's low tax rates were just one ingredient in the successful policy mix.

Box 11.1: Have Ireland's low tax rates been responsible for its economic success? (continued)

Recent measures have been aimed at reducing tax distortions. Ireland has wound back preferential CPT and other subsidies in order to harmonise its tax system with EU requirements and make it less distortionary. As a result of negotiations between Ireland and the EU the preferential CPT will be phased out. The *Finance Act 1999* set out the schedule for achieving a single CPT rate as well as reductions in the top rate of personal income tax to 40 per cent (Walsh 2000).

Box 11.2: The emerging major market of China

China has emerged as one of the fastest growing economies in the world over the last 25 years. GDP has expanded at an average rate of 9.6 per cent over that period, resulting in per capita incomes rising by more than 13 times, from US\$460 per capita in 1980 to US\$5,640 per capita in 2004.³

In PPP terms, China was the world's tenth largest economy in 1980, accounting for a little over 3 per cent of world GDP according to IMF estimates. China's significant growth rates have resulted in it becoming the world's second largest economy, and on current trends it is projected to overtake the United States as the world's largest economy by around 2020.

China's emergence has had a significant impact on world demand for mineral and energy commodities, with China accounting for over 60 per cent of world growth in steel production and coal consumption, and over 30 per cent of world growth in oil consumption and electricity generation, between 1998 and 2004.

- The impact of China's rapid industrialisation, driven by China's comparative advantage in low-end manufacturing, has been a key driver of recent movements in global commodity prices.⁴

FDI and trade

China attracted US\$60 billion dollars in FDI in 2004, with Australia being the thirteenth largest source of FDI, ahead of other large economies such as France, Canada and Italy.

- Large Australian companies have been making substantial investments in China for many years, in manufacturing as well as property, business and financial services.

Looking forward, continuing opportunities exist for Australian business in China, particularly in the financial services sector.

3 Measured on a Purchasing Power Parity (PPP) basis.

4 China's hourly manufacturing labour costs were estimated to average US\$0.57 in 2002 according to a recent study for the US Bureau of Labour Statistics (BLS) (<http://www.bls.gov/fls/chinareport.pdf>). By comparison, the BLS estimated hourly manufacturing labour costs of US\$21.40 for the US and US\$15.41 for Australia in the same period.

Box 11.2: The emerging major market of China (continued)

In terms of Chinese outward FDI, Australia was the fourth largest destination for Chinese investment overseas in 2004, ahead of the United States (sixth), Germany (twelfth) and Japan (sixteenth).

- Chinese enterprises have mostly invested in resource and energy developments and minerals processing, reflecting Australia's significance as a key supplier to China's industrial sector.

Trade with China has grown strongly, with Australia's exports to China growing by 31 per cent in 2004-05 to reach \$13 billion. China is now our second largest export market and trading partner. Export growth has largely been attributable to strong increases in coal and iron ore trade.

- Australia's total trade (exports plus imports) with China reached \$32.8 billion in 2004-05, up from \$16.7 billion in 2000-01.

Going forward, China's continuing industrialisation represents a significant opportunity for the Australian economy. Moreover, initiatives such as the 2003 Trade and Economic Framework agreement, China's WTO accession and Australia's involvement in the 2008 Beijing Olympics and 2010 Shanghai Expo, are likely to support continuing development of economic and trade links with China.

- Negotiations have commenced on a Free Trade Agreement with China, which is likely further to enhance trade and investment linkages between the Australian and Chinese economies.

Tax aspects

Australia imposes a lower corporate tax rate on its inbound FDI (30 per cent versus 33 per cent for China on the profits of branches and subsidiaries of foreign multinationals).⁵

- Australia and China are not necessarily competing for the same FDI dollar from key capital exporters like the United States (and in trade, Australia has significant complementarities with China). Australia generally attracts FDI to its resources and high-skills services sectors, whereas China is likely to continue to attract FDI to its manufacturing and construction sectors.

Australia has a higher top personal tax rate (48.5 per cent versus 45 per cent for China).

- While China is sixth in terms of countries that high-skilled persons in Australia depart to (Chart 11.1), Australia is gaining high-skilled persons in net terms from China (Chart 11.3).

It is not clear that tax is (or will be) a significant factor in Australia's ability to attract the capital and skills it needs in the context of the emerging major market of China.

5 Foreign investment enterprises (FIEs) in China may be taxed at reduced corporate rates (for example, 15 per cent, or even exempt), depending on location and type of business.

Box 11.3: The emerging major market of India

Since embarking on a programme of economic reforms in the early 1980s, which gained momentum in the 1990s, India has emerged as one of the world's fastest growing major economies. Over the last 25 years, India's GDP has expanded at an average annual rate of almost 6 per cent. Over the last three years, growth has averaged above 7 per cent.

As a result, India has grown from being the ninth largest economy in the world in 1980, in PPP terms, to being the fourth largest economy in the world. If current growth rates are sustained, India will overtake Japan in the next few years to become, in PPP terms, the third largest economy in the world (behind only the United States and China).

Despite India's emergence, it remains a relatively closed economy and positive spill-overs from Indian growth have been limited. Nonetheless, as India becomes more integrated with the global economy, it is becoming a greater source of regional and global growth, which is benefiting many countries, including Australia.

Trade and FDI

Over the last five years, India has been one of Australia's fastest growing merchandise export partners, and has now overtaken the United Kingdom to become Australia's sixth largest export market. In 2004-05, exports of goods and services to India amounted to almost \$7 billion. This compares to imports of around \$1.5 billion, giving Australia a large trade surplus with India.

- Australia's exports to India are dominated by commodities, including gold and coal, and by tertiary education. In contrast, imports are mainly in traditional areas such as gems, floor coverings and jewellery.
- Prospects for trade with India continue to improve as trade liberalisation progresses.
 - The information and communications technology (ICT) services sector, biotechnology, and trade in services including health, education, film, tourism, insurance, energy and power, all continue to show promising potential for growth.
- In March 2006, Australia and India signed a Trade and Economic Framework agreement. The agreement is expected further to boost economic and trade links between the two countries.

Although growing, FDI linkages between India and the world remain relatively low, especially when compared to China. In 2004, India attracted around US\$5 billion of FDI inflows and was the source of around US\$2 billion in outflows, mainly from and to major trading partners.

The low levels of FDI linkages are partly because India is still in the process of liberalising its foreign investment regime. Other factors such as poor infrastructure and administrative procedures, and labour market inflexibility, are also barriers to investment in India.

Box 11.3: The emerging major market of India (continued)

While FDI flows between Australia and India have been small to date, there are indications that they are on an upward trend.

Going forward, India will continue to have a high potential growth rate for many decades, largely due to its favourable demographics. This is because India is one of the few countries in the world where the population is expected to keep growing over the next 50 years, and more importantly, where the proportion of working-age people will increase well into the 2020s.

Tax aspects

Australia imposes a lower corporate tax rate on its inbound FDI (30 per cent versus 41.82 per cent for India, on the profits of branches and subsidiaries of foreign multinationals).

- Australia and India are not necessarily competing for the same FDI dollar from key capital exporters like the United States.

Australia has a higher top personal tax rate (48.5 per cent versus 30 per cent plus a 10 per cent surcharge for income above Rs 1 million (about A\$30,000) plus a 2 per cent education levy on income tax plus surcharge for India).

- India is not one of the top ten countries that high-skilled persons in Australia depart to.

It is not clear that tax is, or will be, a significant factor in Australia's ability to attract the capital and skills it needs in the context of the emerging major market of India.

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