STATE-FIRM BARGAINING AT THE SUBFEDERAL LEVEL: THE CASE OF CALIFORNIA'S UNITARY TAX

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Ph.D. Thesis in International Relations

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Abstract

This thesis models negotiations over U.S. subfederal economic policies that conflict with international norms. It analyses a recent case of a U.S. state government bargaining with foreign entities over a subfederal economic regulation which violated international norms: California's system of worldwide combined unitary taxation.

The thesis applies Stopford and Strange's framework of state-firm bargaining to the subfederal level by: 1) determining which actors were involved in lobbying to change a U.S. state economic policy which violated international norms, California's unitary tax method; 2) determining the actors' policy agendas; 3) determining the different types of political and economic assets each actor possessed, and how effectively the actors used these assets to achieve their policy agendas; 4) determining how effectively the actors used various channels of negotiation to influence California's policy, and; 5) determining the most effective uses of assets and negotiating channels, key initiatives which influenced the outcome of the policy debate.

What happens when U.S. state economic regulations conflict with international norms? What capabilities do states possess to defend their regulations when bargaining in the international arena? This thesis will argue that in the case of California's unitary tax, the following hypotheses are valid:

1) Poweful U.S. states such as California can maintain regulatory standards at odds with federal and international norms. Growing global economic interdepence is not eliminating California's regulatory options, since the U.S. federal government often refuses to effectively constrain powerful states which violate federal and international norms.

2) U.S. state governments can bargain directly with foreign governments and multinational enterprises as actors in the international arena. As the international arena increasingly intrudes on the affairs of subfederal governments, the U.S. federal

government will not always be the preeminent negotiating channel for international actors seeking to influence U.S. economic policies.

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Dedication

This is for Laura and Kate, who taught me everything.

List of Abbreviations

AB	Assembly bill
ACT	Advance corporation tax
ADEPT	Assembly Democratic Economic Prosperity Team
AGP	Agreement on Government Procurement
ALS	Arm's length standard
BIAC	Business and Industry Advisory Council
BOE	Board of Equalization
CBC	California Business Council
CBI	The Confederation of British Industry
CIME	Committee on International Investment and Multinational Enterprise
CMA	California Manufacturers Association
COST	Committee on State Taxation
CPI	Comparable profit interval
CSG	Council of State Governments
CTJ	Citizens for Tax Justice
CUP	Comparable unrelated price
CUTC	California Unitary Tax Campaign
DISCs	Domestic international sales corporations
DSB	Dispute settlement body
EC	European Community
EU	European Union
FCN	Treaty of Friendship, Commerce and Navigation
FSC	Foreign sales corporation
FTA	Federation of Tax Administrators
FTB	Franchise Tax Board
GAO	General Accounting Office

GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
HR	House of Representatives
ICC	International Chamber of Commerce
INS	Immigration and Naturalization Service
IR	International relations
IRS	Internal Revenue Service
ITC	International tax counsel
JBA	Japan Business Association of Southern California
LDC	Less-developed country
MAI	Multilateral Agreement on Investment
MFN	Most-favoured nation
MNE	Multinational enterprise
MTC	Multistate Tax Commission
NAFTA	North American Free Trade Agreement
NAM	National Association of Manufacturers
NATA	National Association of Tax Administrators
NATP	National Association of Tax Practitioners
NCG	Non-central government
NCSL	National Conference of State Legislatures
NFTC	National Foreign Trade Council
NGA	National Governors' Association
NGO	Non-governmental organisation
NTA	National Tax Association
NTB	Non-tariff barriers to trade
OECD	Organisation for Economic Cooperation and Development
OFII	The Organization for International Investment
OFTII	Organization for the Fair Treatment of International Investment
SAA	Statement of administrative action
SB	Senate bill
TEI	Tax Executives Institute

UDIPTA	Uniform Division of Income for Tax Purposes Assessment
UN	United Nations
USCIB	U.S. Council for International Business
UTC	The Unitary Tax Campaign
WGA	Western Governors' Association
WTC	World Trade Commission
WTO	World Trade Organisation
WWC	Worldwide combination

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Chapter 1: Introduction

1) Research problem

While International Relations (IR) theorists have begun to recognise the existence of U.S. states as players in the international economic arena, their ability to negotiate with multinational enterprises (MNEs) over economic policies is seen as significantly limited by the traditional dominance of the U.S. national government in foreign relations.[1] Presumably, federal political and legal constraints would combine with internal competition between U.S. states for investment to prevent U.S. subfederal governments from imposing economic policies which would deter the mobile capital controlled by MNEs.

However, the U.S. federal government has often judged it politically expedient to allow state governments free rein in formulating economic policies which conflict with national government policies. Under the country's constitution, U.S. state governments are allowed a great deal of independence and hold much of the law-making power to regulate and attract economic activity. U.S. states have been active in attracting MNEs to their jurisdictions through economic incentive packages,[2] and several U.S. state legislatures have issued political statements on international issues or imposed state-wide economic sanctions against MNEs doing business in international hotspots.[3]

At the same time, the blanket presumption of a race to the regulatory bottom by U.S. state governments eager to attract international investment assumes a homogeneity of state interests and attractiveness to investors. Although states often strive towards more uniform regulations to ensure their local jurisdiction's competitiveness in the global marketplace, all jurisdictions have needs besides maximising economic return: such needs ensure the survival of corporate regulation at the local level.[4]

The economic regulatory policies of U.S. state governments have increasing worldwide repercussions with the growth of international trade and investment within state jurisdictions, since U.S. state governments control relatively large economies which cannot easily be ignored by MNEs.[5] At the same time, multinational enterprises are becoming more "statesmanlike" as they seek to enhance their ability to compete for world market share.[6] Companies can legally protest state regulations before state governments, the U.S. federal government, U.S. courts, or international organisations, and companies headquartered outside of the United States can draw on their home governments to protest subfederal economic policies. This can lead to negotiations between U.S. federal and state governments, between the U.S. federal government and foreign governments, between foreign national governments, and between various actors over judicial strategies. The increase in international economic interactions at the U.S. subfederal level has thus multiplied the number of actors and channels which influence U.S. state economic policies.

This thesis will begin the process of modeling negotiations over U.S. subfederal economic policies which conflict with international norms. Although every policy debate will have anomalies and distinct interest groups which participate based on the issues under dispute, fixed dimensions to international negotiations over U.S. state economic policies can be laid out. These dimensions differ from those present in traditional negotiations between national governments and MNEs over economic policies. Economic interdependence theorists have generally focused on changes in the international system, and paid less attention to the accompanying transformations in foreign policy processes. This paper will attempt to examine the operation of U.S. states in the international political economy by looking at newly evolving modes of negotiation over subfederal economic policies.

2) The issue examined

This thesis will examine a recent case of a U.S. state government bargaining with foreign entities over an economic regulatory policy which violated international norms: California's system of worldwide combined unitary taxation. This tax method, used in

California since the early 1960s, applies a standard formula to apportion the income of a multinational enterprise among the different tax jurisdictions in which it operates.

California's unitary tax method became an international issue because of the method's extraterritorial reach into foreign tax jurisdictions. In addition, although California applied the regulation equally to MNEs and companies which operated only within the United States, the tax method had a much greater effect on MNEs than on purely domestic companies, since MNEs had part of their profits taxed by foreign governments which used the competing arm's length standard (ALS) of taxation. Since there is no overarching international mechanism to make sure a company is not double-charged on its profits by different tax jurisdictions, MNEs operating in California claimed they frequently paid money to two different tax authorities on one set of profits.

California's unitary tax system conflicted with both U.S. national policy and America's bilateral international tax agreements. Despite the extraterritorial implications of the state's policy, California was not directly bound by international agreements which promulgated the alternative ALS taxation method, and no enforceable international tax regime existed to curtail the state's use of the unitary method. In addition, the nature of U.S. federalism, along with California's clear political and economic priorities, powerful economy, and strong political position within the United States, led the national government to refrain from outlawing the method.[7]

However, California's use of the unitary tax method was challenged by the U.S. federal government, foreign governments, international organisations, and both foreign and domestic-domiciled MNEs. As a result of these pressures, and in the face of the state's growing dependence on the world economy, California modified its unitary tax method in both 1986 and 1993. The state ultimately changed its tax method to accord with international norms in order to remain an attractive destination for international trade and investment as California grew more dependent on out-of-state trade and investment. However, the state had enough power to modify its regulations in the manner most advantageous to it: initially, California maintained the right to overturn a company's decision to file under the alternative ALS method and charged a fee to companies which

did so; in 1993, despite eliminating these restrictions, California maintained the principle that the state had the right to apply the unitary tax method, avoiding the payment of back taxes under a legal decision at a time when California was suffering financially.

The California unitary tax issue is the most prominent recent case of a subfederal jurisdiction clashing with MNEs over economic regulations which focused primarily on promoting subfederal economic welfare. California is a powerful state, and the debate over its tax method was lengthy, complex, and appealed to the highest levels of arbitration. It is important to examine and understand the debate which took place over this issue. Through looking qualitatively at this case, and examining its dynamics, this thesis hopes to sketch out how international actors can influence U.S. state economic policies which conflict with international norms, even those put forth by very powerful states.

Since only one case is being examined, it is equally important to state what the thesis will not do: it will not attempt to draw general conclusions on how international actors influence U.S. state economic policies, or even to draw general conclusions on how international actors influence U.S. state laws which conflict with international norms. The operation of international economic forces at the subfederal level is an important new field of research where little work has been done. This case study will contribute to the examination of international relations at the subfederal level by collecting and analysing data related to the policy debate over California's unitary tax method. Further, it will provide an original contribution to the field of international political economy by applying state-firm bargaining theory to the subfederal level.

3) Locating the issue in the theoretical realm

Despite agreement among many political economists that interdependence has sapped the power of the nation-state and permeated domestic structures,[8] the roll call of actors who are recipients of this disseminated power almost never includes subfederal governments. Latouche (1988) claims that some non-state actors (MNEs, labour associations, and nongovernmental organisations [NGOs]) have dominated IR theory at

the expense of others (states, regions, and cities). On the rare occasions that U.S. state governments are included in the roll call of international actors, they have been grouped with MNEs and NGOs as transnational actors, leading most of the academic work to focus on the states' trade and investment promotion efforts overseas, and ignoring their importance as domestic market regulators of international interactions.

Yet political economists have realised that domestic structures are critical to understanding different national policy responses to interdependence.[9] Economic matters have traditionally been a key area of concern for local authorities, and the internationalisation of economic production means a growing number of local jurisdictions contain businesses dependent upon the international market for survival. At the same time, rising interdependence means that international economic events increasingly impact 'ordinary people' who need the support mechanisms provided by subnational governments, since traditional channels of statecraft are often ill-equipped to deal with economic matters.[10]

The subnational units most often cited as examples of this new international activism exist in Western federalist democratic countries (the U.S., Canada, Australia, Switzerland, and Germany). If there is already a division of authority between national and regional governments, international activism will come much more naturally to subnational authorities. Subnational governments in federal democracies hold much of the law-making power to regulate and attract economic activity.

Scheiber, Soldatos, and Kline point out that U.S. state intervention in international economic matters has long historical antecedents: "the role of federated and other subnational units in external relations is not new".[11] Sporadic disputes that challenged the national government's treaty enforcement powers over the states occurred through the early 1800s, "such as South Carolina's imprisonment of black British sailors in contravention of a bilateral commercial convention and its declared nullification of a national tariff as applied within the state's borders".[12] Taking the long view from the early nineteenth century, Scheiber argues that the U.S. legal and governmental system has always had an elaborate mosaic of economic policies at the state level representing each

state's distinctive economic interests. "As a working system, United States federalism...has left enormous room for intervention by the states with respect to economic institutions and policies".[13]

While most paradiplomacy theorists recognize that examples of U.S. states being able to interact directly with the international arena have occurred throughout the history of the United States, they argue that, starting in the late 1960s and early 1970s, the increase in international economic transactions in the U.S. domestic economy brought about a qualitative shift in U.S. states' interest in and ability to bargain in the international arena.[14] Paradiplomacy theorists agree that expanding U.S. state international involvement during this period resulted from "the growing impact of international economic forces on the domestic economy"[15] in the late 1960s as "(i)ntrastate actors...reacted to systemic changes at the level of the nation-state and the emergence of an increasingly interdependent world by becoming directly involved internationally".[16] The growth in overseas involvement was seen by U.S. states as "essentially...an extension of traditional state economic development efforts to reflect the new importance of international factors in the U.S. domestic economy".[17]

This greater involvement has occurred on two levels. Qualitatively, subfederal jurisdictions more frequently deploy their own channels and spend substantial amounts of their own financial resources to pursue their foreign-policy objectives. Quantitatively, the "external activity of federated units...is unprecedented...in that its pace has accelerated as it has become increasingly wide in scope...and in relationships (measured by volume of interaction and by number of partners)".[18]

Fry claims that the end of the Cold War, and the accompanying shift in U.S. foreign policy priorities towards economic issues, further accelerated the involvement of U.S. subfederal units in the international arena. "Foreign direct investment in the U.S. increased over 400 percent from 1983 to 1993".[19] U.S. exports as a proportion of GDP increased 50 percent from 1984 to 1988,[20] and state appropriations for international trade promotion programs increased 260 percent.[21] From 1984 to 1989, the number of state overseas trade offices more than doubled, from 56 to 132.[22]

The states' increased involvement in international trade and investment has translated into increased concern over U.S. involvement in international trade treaties and economic agreements. "The states' international activities also lead to a greater number of direct contacts with foreign government officials, adding a public officeholder dimension to the multiplying channels of private sector communications".[23] Of course, there is obviously a fairly wide variation in the resources individual states can devote to international trade and investment promotion, and in the amount of a state's gross product which is dependent on international economic activity. California, Florida, New Jersey, and New York are among the most prominent state players in the international arena.

At the same time, the increase in foreign direct investment in the U.S. over the course of the 1980s resulted in the increased application of state regulatory processes to a growing number of foreign companies investing in the U.S.[24] Scheiber argues that it is the increased reliance of the states on the international economy, and the consequent increased importance in the states' regulatory roles in taxation, antitrust, environment, and other policy fields, rather than the mere increase in U.S. state offices abroad, which has truly allowed states to bargain in the international arena.

Each U.S. state has its own distinct combination of natural resources, labour, corporation, taxation, and general regulatory policies, including environmental, product liability, and antitrust regulations.[25] Many U.S. states are developing their own industrial policies, providing export aid, low-interest loans, technical assistance, and extensive investment incentives. By using their regulatory and industrial powers, state governments create a climate within their jurisdictions that encourages or discourages various types of international economic transactions, including trade, tourism and investment. States also implement and enforce provisions of U.S. federal law, including international treaties and trade agreements.[26]

U.S. states have also used their regulatory powers to project economic policies which serve political goals into the international arena. In an attempt to serve as a model for other jurisdictions, local and state finance officers pressured Swiss banks to respond to

claims made by Holocaust victims and their heirs; the state of Massachusetts passed economic sanctions against Burma; state governments established penalties against companies participating in the Arab boycott of Israel in the mid-1970s; and 150 U.S. state and local governments passed economic sanctions against South Africa in the 1980s.[27] When state and local governments are motivated by political concepts relating to justice and human rights, not enhancing the economic welfare of their citizens, subfederal activity may pose a clearer infringement on a federal government's foreign policy authority.[28] Although this thesis will examine examples of recent state economic sanctions in its concluding chapter, it will focus on California's unitary tax method as an example of international negotiations over a subfederal policy issue where the primary intent of the policy was to promote the state's economic welfare.[29]

Braithwaite and Drahos believe this type of action on the part of states can be effective since the globalization of regulation and legal systems is often achieved by observational learning through a process they describe as 'modeling'. A model is a "conception of action that is put on display...symbolically interpreted and copied",[30] and modeling is patterned according to configurations of power.[31] However, Braithwaite points out that "(t)hose imputed low status by a dominant power can choose to solve their status problem by creating new status systems that invert the hegemonic status system".[32] In this regard, U.S. states can be seen as an example of Braithwaite's 'model mongers', actors that experimentally float oppositional models. "Because states are not unitary in a way that realist theory supposes, it is possible for weak actors to enroll the power of embattled minority fractions of powerful states in ways that can be transformative".[33] Persistent application of this strategy can eventually draw out contradictions in the dominant model for transfer pricing regulation, the arm's length model. "Once oppositional models have currency, they become a resource for drawing out contradictions in the identities propagated by majoritarian models"[34] and creating a minority constituency for the oppositional model, in this case the unitary tax.

The nature of U.S. federalism limits a straightforward imposition of international or federal law on U.S. state economic regulations. The division of authority between federal and subfederal governments is often gray, particularly in the economic arena,

providing leeway for subfederal units to act internationally.[35] Duchacek refers to the intertwining of national and subfederal actors in a "marbled diplomacy" where functions are mixed and both sides search for some type of cooperation.[36] Indeed, the U.S. national government appears willing to accept a greater state role in defining investment and trade opportunities, with the notion that more localised governments have a greater understanding of opportunities for specific businesses. In turn, U.S. states have come to regard market regulation as within their policy domain, and resent having this power modified by the federal government.

Although the U.S. Constitution clearly gives the federal government predominance in foreign affairs, in practice, states often engage directly with the international economic system to promote their jurisdiction's economic welfare. "In effect, there is a major difference in the U.S. system between what is constitutionally permissible and politically expedient".[37] U.S. courts have not always used their power to overturn state laws which potentially conflict with federal regulations or international treaties, instead ruling that only congressional laws which specifically contradict state law can override state economic policies. This judicial view has resulted in increased lobbying of the U.S. Congress by both state and business interests, which has proved reluctant to preempt state interests. The United States' accession to international economic policy agreements have been followed by broad exceptions for state policies in the U.S. legislation which implements these agreements into U.S. law.

Such weak legal constraints have led some theorists to propose the use of "soft law" practices for regulating U.S. state activity in the international economic arena. Soft law consists of "politically agreed guidelines for behaviour which cannot be directly legally enforced but cannot either be legitimately infringed",[38] and encompasses such areas as voluntary agreements and codes of conduct, as opposed to formal treaties. The construction of a complex maze of regulatory networks often occurs through direct interactions between officials with professional knowledge of a specific subject.[39] Duchacek states that "(I)n contrast to domestic law, in international relations...no common superior authority can be invoked in case of violation. Yet...such unenforceable bargains are generally observed, since both sides continue to have a very similar interest

in preserving the assumed advantage assured by the initial bargain".[40] Further, "economic competition is itself a co-ordinative and regulatory mechanism".[41] Thus, the 'unseen hand' of the market-place can be seen as a form of soft law. Indeed, despite California's unusually strong power for a subfederal unit, at the end of the debate over its unitary tax method, the state made the same calculations as countless national governments before it, and decided that a short-term revenue loss from dropping unpopular regulations was outweighed by the long-term potential of increased investment from its adherence to international norms.

4) Modeling paradiplomacy

Subfederal activism in the international arena is a new area of study, with few theorists in either International Relations or comparative federalist studies.[42] Most academic work has concentrated on either central-regional government coordination of external relations or economic development models for subnational units.[43] It is only recently that this new level of international activism has been given the label 'paradiplomacy'.

"The term paradiplomacy...refers to direct international activity by subnational actors...supporting, complementing, correcting, duplicating, or challenging the nation-state's diplomacy; the prefix 'para' indicates the use of diplomacy outside of the traditional nation-state framework".[44] Since subnational international activity, in advanced industrialised countries, tends to focus on economic issues, as a result of both budgetary constraints and ideological considerations, paradiplomacy has relied more on private actors than traditional statecraft.[45] It is therefore often more functionally targeted than conventional state diplomacy, and more experimental.[46]

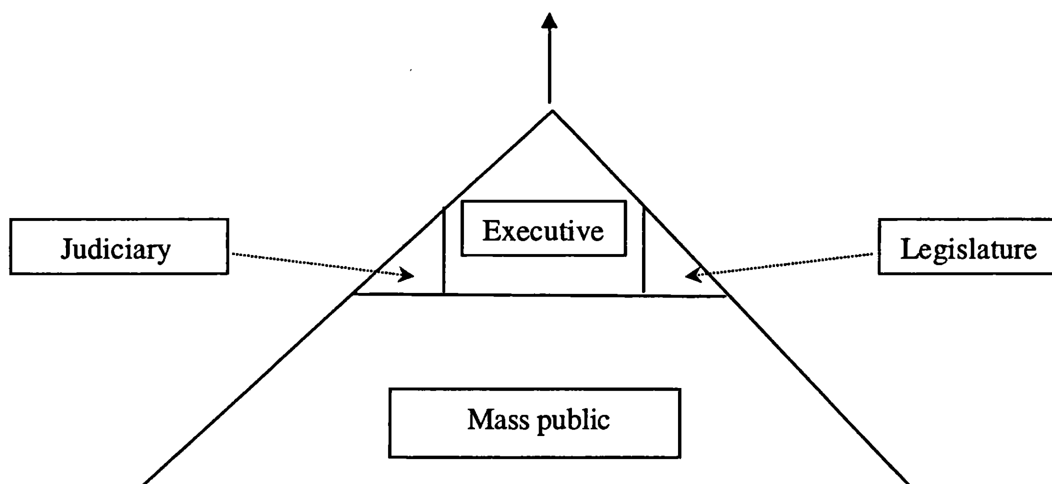
However, the external relations of subfederal jurisdictions are like national foreign policies in many ways, in that subfederal units create institutions to fulfill their policy objectives by maintaining international links, conducting international transactions, and even concluding agreements with foreign actors.[47] Of course, subfederal units do not always act completely outside the parameters of national foreign policies.[48] Subfederal

governments can build on the existing channels and content of national foreign policies, but use them to further their particular interests. Duchacek concludes that "If by diplomatic negotiation we mean processes by which governments relate their conflicting interests to the common ones, there is, conceptually, no real difference between the goals of paradiplomacy and traditional diplomacy. Both sides pledge a certain mode of future behaviour on the condition that the opposite side act in accordance with its promise".[49]

Duchacek finds two models can be used to examine the phenomenon of paradiplomacy:

1) The Chepos Paradigm, which shows the nation-state as a univocal actor speaking to foreign governments with a single voice, that of the executive branch. The Chepos Paradigm is modeled below in Figure 1. The nation-state is modeled as a pyramid, whose apex, the only voice to the outside world, is formed by the executive branch, monitored and restricted on either side by the legislature and the judiciary. The large base of the pyramid is the mass public, which has no independent means of relating to the outside world.

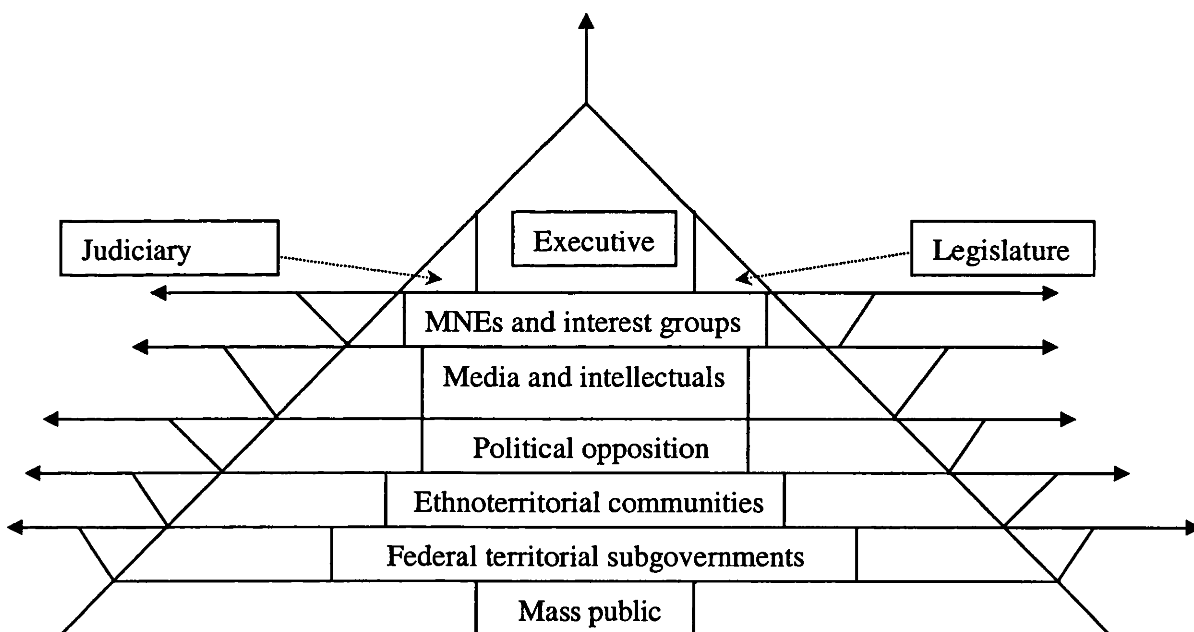
Figure 1: Chepos Pyramid



2) The Saqqara Paradigm, a stepped pyramid, shown below in Figure 2. While this pyramid has the same apex, the central government, there are many layers of actors

between the apex and the mass public which can access the international arena, although the mass public still has no means of communication with the outside world. Each of these layers has two small apexes which serve as conduits to foreign centers of power. These sublayers include: the media and intellectuals, functional interest groups (including NGOs and MNEs), the political opposition, ethnoterritorial communities, and federal territorial subgovernments.

Figure 2: Saqqara pyramid



Soldatos (1990, 1993) also attempts to model subfederal diplomacy. He states that when the different levels of territorial government within a country directly involve themselves in foreign policy, the result is the 'vertical segmentation' of foreign policymaking. These different levels of governments within a country can be segmented in their views of how to conduct foreign policy through different perceptions and loyalties; different economic, geographic, political, linguistic, cultural or religious

characteristics; and different policy stances. Different layers of government within a nation-state can therefore speak authoritatively to foreign powers on the same policy issue, but often from different positions.

Both these theorists describe a fairly static model of paradiplomacy which focuses on the outward actions subfederal jurisdictions take to influence the international arena. Hocking (1992, 1999) instead views international diplomacy as networks of actors who interact in different ways depending on the salience of the issue at hand, their interests, and their capacity to operate in the various environments where policy decisions are being made.[50] He believes paradiplomacy unjustly places non-central governments (NCG) activity outside the mainstream of diplomacy, and seeks to reincorporate NCGs within the foreign policy process, which he believes is a "`multilevel' political environment spanning subnational, national and international arenas", an environment which forces decisionmakers to negotiate simultaneously in several non-hierarchical, interlinked political arenas.[51] This presents a view of federalism which "emphasises powersharing and the evolution of cooperative relationships between levels of government characterised by bargaining processes".[52] Hocking therefore has a more dynamic and fluid view of subfederal government involvement in the international arena.

As stated earlier, the increase in international economic interactions at the level of U.S. states has multiplied the number of actors and channels which influence negotiations over U.S. state economic policies. In this context, multilayered bargaining offers a more dynamic view of foreign policy processes at the subfederal level than traditional models of paradiplomacy. This thesis will further Hocking's theories of multilayered diplomacy by applying Stopford and Strange's model of state-firm bargaining to the subfederal level.

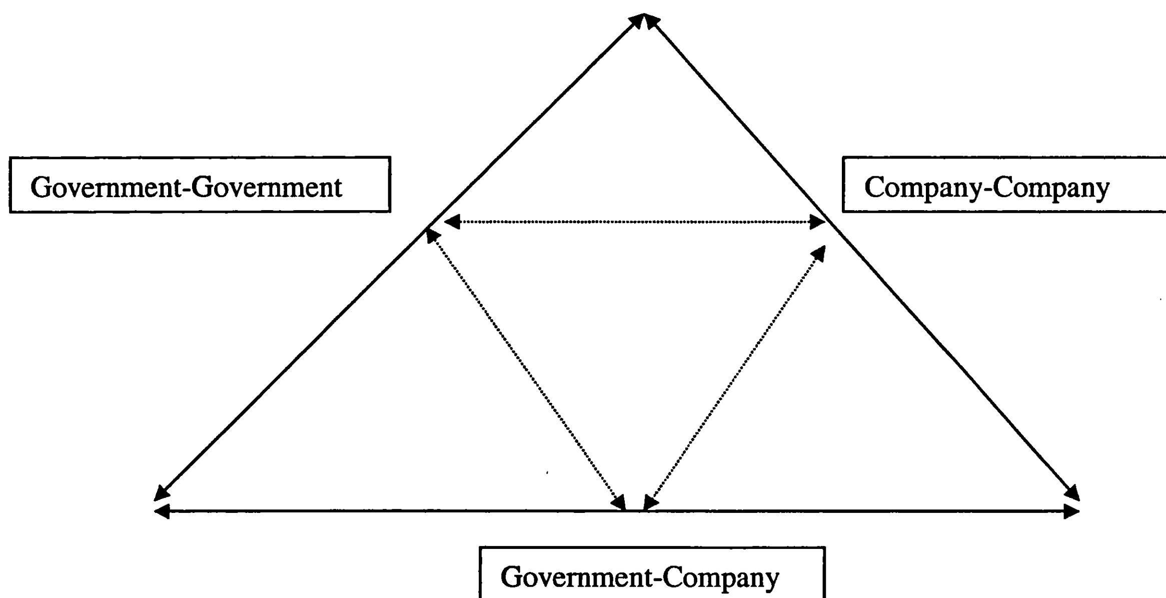
5) Methodology

a) Multilayered state-firm bargaining theory

Susan Strange (1975, 1985, 1991, 1992, 1996) asserts that International Political Economy must examine negotiations over economic policies which are conducted outside the traditional channels of national government diplomacy and which involve the

participation of non-state actors such as MNEs. Doz (1986), Behrman & Grosse (1990) and Stopford & Strange (1991) all describe the negotiations which take place between MNEs and governments over economic policies. These negotiations can include traditional diplomatic negotiations between national governments when MNEs enlist their home states' help in negotiating with host nations. At the same time, MNEs can negotiate to form alliances with other firms in an attempt to influence government policies, and governments can form alliances in an attempt to more effectively regulate MNEs. These international negotiations enter the realm of domestic political economy when MNEs seek to influence their home governments' policies.[53] Stopford and Strange argue that MNEs and governments are now linked in a triangular set of diplomatic interactions as both seek to develop strategic alliances in the pursuit of wealth.[54] This model of triangular diplomacy is shown in Figure 3 below.

Figure 3: Stopford and Strange's triangular diplomacy



Stopford and Strange describe the various sets of negotiations over economic policies which take place between an assortment of actors in both the international and domestic arenas. They state that the effectiveness of these actors in achieving their objectives is strongly determined by the resources they possess and the different

negotiating channels they employ. They describe a dynamic, multilayered bargaining framework. But they do not apply it to the subfederal level.

b) Applying state-firm bargaining to the subfederal level

This thesis will apply Stopford and Strange's framework of state-firm bargaining to the subfederal level to examine the debate over California's unitary tax method. The thesis thus expands the field of paradiplomacy by modeling negotiations over U.S. subfederal economic regulations, and expands the base of state-firm bargaining theory by applying it to the subfederal level.

Although the framework of state-firm bargaining has not been applied to the subfederal level, it is clear that subfederal governments which control economic resources and regulate markets are able to engage in negotiations with firms over their economic policies. In addition, the nature of U.S. federalism limits a straightforward imposition of international or federal law on U.S. state economic regulations. This has resulted in a widened legal arena for U.S. state regulatory actions and a correspondingly greater need for firms to directly influence U.S. state economic policies.

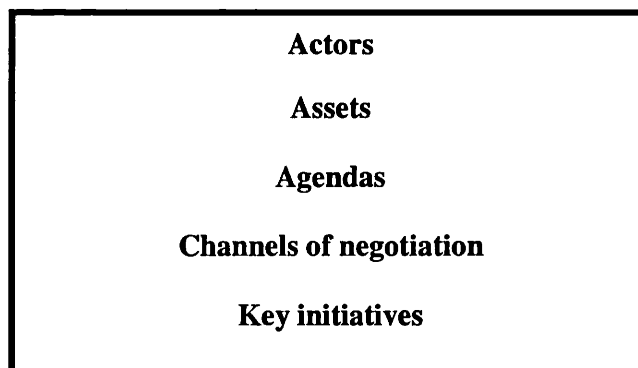
However, relevant negotiations may not always be between an MNE and a U.S. state government: equally important are negotiations between the subfederal and federal government, within court cases, between firms within industry associations, or between foreign governments and the U.S. federal government.[55] Various sets of different negotiations are thus taking place, often simultaneously, and each set of negotiations can influence others. This variety of interactions makes the formulation of state policies with international implications a dynamic and complicated arena in need of further examination.

c) The model

In applying state-firm bargaining to the subfederal level, the thesis will examine the policy agendas which each actor brought to the debate over California's unitary tax method, and attempt to draw conclusions over which assets and channels of influence enabled the actors to achieve their objectives. It will do this by: 1) determining which

actors were involved in lobbying to change California's unitary tax method, a U.S. state economic policy which violated international norms; 2) determining the actors' policy agendas; 3) determining the different types of political and economic assets each actor possessed, and how effectively the actors used these assets to achieve their policy agendas; 4) determining how effectively the actors used various negotiating channels to influence California's policy, and; 5) determining the most highly effective uses of assets and negotiating channels, key initiatives which influenced the outcome of the policy debate. Box 1, below, outlines the components of the state-firm bargaining model at the subfederal level. The following section will define each component of this model.

Box 1: Components of the state-firm bargaining model at the subfederal level



i) <u>Actors</u>

The increase in international economic interactions within the U.S. has multiplied the number of actors which are influenced by U.S. state regulations. It is necessary to define the motivations and resources of these various actors in order to understand the negotiations taking place over U.S. state economic policies with international implications.

According to Hocking, there is a "continuing urge to stress the separateness of different categories of actor (*state vs. non-state*) and to view the relationships between them in zero-sum terms – epitomised by often sterile debates as to the relative power of different categories of actor".[56] However, non-central governments contain some of the qualities of state actors, such as sovereignty, territory, and access to national diplomatic

networks, and some of non-state actors, since their "status ambiguity" means non-central governments "can often afford to take firm positions on issues...which national governments will need to balance against broader international policy considerations".[57] Non-central governments therefore exemplify the erosion of boundaries between foreign and domestic politics which has created the multi-layered political environment in which both governmental and non-governmental actors seek to influence policy decisions. The number and variety of interactions between actors seeking to influence policy issues in the international arena have greatly increased.

In such a fluid environment, "conflicts are prosecuted and resolved primarily on the basis of ad hoc power plays and bargaining among combinations of these groups – combinations that vary from issue to issue".[58] Interaction between these various actors depends on the issues at hand, the interests of the various actors, and their capabilities to influence outcomes.[59] When examining the actors involved in influencing U.S. subfederal economic policies, the thesis will classify the actors into different types: firms, state governments, national governments, and international organisations. However, these classifications do not determine the importance of the actors to the policy debate or preclude combinations between the various categories of actors during the negotiating process.

ii) Agendas

The model will next examine each of these actor's policy agendas, both on U.S. subfederal tax issues in general and with regards to California's unitary tax method in particular. Stopford and Strange's description of state-firm bargaining stresses the importance of taking into account the contradictory pulls from various bargaining relationships which provide multiple, related agendas for actors in both the international and domestic arenas. This thesis will describe the multiple, often conflicting, agendas each actor pursued in the debate over California's unitary tax method.

iii) Assets

In attempting to influence subfederal economic policies which violate international norms, the effectiveness of the actors in achieving their policy agendas is

strongly determined by the resources they possess.[60] "Power can be thought of as the ability of an actor to get others to do something they otherwise would not do (and at an acceptable cost to the actor). Power can also be conceived in terms of control over outcomes".[61] Keohane and Nye define power as the control over resources which give an actor the *potential* to affect outcomes, and the thesis will follow this definition.[62] The model will therefore evaluate the assets the actors possess upon entering into the bargaining process, the resources which give actors the potential to affect subfederal economic policies.

The model used here occasionally separates these assets into political assets and economic assets. As defined here, political assets are those which give an actor the ability to influence policy directly. Political assets constitute resources such as an actor's rights under a jurisdictional legal structure, access to key decisionmakers, hold over popular opinion, or the ability to marshal support for a political leader who can formulate policy. Economic assets are defined as resources which allow an actor to indirectly influence a policy debate by the weight of an actor's importance to the marketplace, and include access to proprietary technology, capital, key skills, natural resources, and markets. Obviously, political and economic assets interact with and influence each other: for example, a government's economic asset in a particular situation may be simply that it has the sovereign political right to set the rules of operation for a particular market.[63]

iv) Channels of negotiation

State-firm bargaining does not take place in a vacuum. There is always an institutional setting for negotiations between actors, and these institutions play an important role in structuring and influencing the bargaining process itself. When actors bargain, when they attempt to deploy their assets, they do so through channels of negotiation. In Hocking's view of multilayered diplomacy, the most interesting and challenging tests confronting actors seeking to influence policy is to identify the levels of government at which they can operate most effectively.[64] This thesis will evaluate how effectively the actors used, or did not use, appropriate negotiating channels to deploy their assets during the debate over California's unitary method.

As defined by Behrman, Boddewyn and Kapoor, channels of negotiation consist of actors that can be used to influence a host government.[65] These channels can consist of, among others, home governments, MNEs, state or municipal governments in the host country, common-cause groups, law firms, banks, chambers of commerce and industry associations, and regional or multinational intergovernmental organisations.[66] Therefore, many of the actors active in state-firm bargaining at the subfederal level can also be considered to be negotiating channels for other actors. This model of bargaining at the subfederal level includes the negotiating channels of the U.S. federal government, the state of California, the U.S. court system, and international organisations.

v) Key initiatives

When actors effectively deploy their assets through channels of negotiation in bargaining over subfederal economic policies which violate international norms, they put forward initiatives which lead to solutions in accord with their policy agenda. The key determinant of such a successful initiative is the "direct and discernible effect of an action".[67] Keohane and Nye state: "There is rarely a one-to-one relationship between power measured by type of resources and power measured by effects on outcomes. Political bargaining is the usual means of translating potential into effects, and a lot is often lost in the translation".[68] Further, the translation from capabilities to outcomes depends, to a large extent, on skillful political bargaining.[69]

Such highly effective uses of assets, deployed through effective negotiating channels, can change the circumstances of a policy debate and lead to a solution. Such key initiatives can be considered the culmination of state-firm bargaining in that they are the most effective means by which an actor's assets, its potential to affect outcomes, are translated into influence over the outcome of the debate.[70] Highly effective uses of assets and negotiating channels will thus be highlighted when analysing the outcomes of the debate over California's unitary tax method.

vi) The question of regimes

Keohane and Nye postulate an intermediate factor between the power structure of the international system and the political and economic bargaining that takes place within

it: international regimes. Such regimes are "networks of rules, norms and procedures" that regularise and control interdependence, and include national, international and private rules.[71] These networks of interacting rules influence and direct the political bargaining that takes place within an interdependent system.[72] Therefore, the international regime relevant to the case of California's unitary tax method, the `rules of the game' governing international taxation, will be included in the analysis of the policy debate

d) Research approach

Research to determine the actors, their agendas, their assets, and the various channels of negotiation in the debate over California's unitary tax method consisted of surveying a wide variety of participants in the debate to allow an assessment of the relative importance of different actors and negotiating channels in the "judgments of well-placed observers".[73] In order to begin determining which institutional actors were most involved in the debate in California, a large amount of primary material was collected from the U.S., including the unitary tax legislation itself, tax journals which tracked the debate on a daily basis, industry newsletters, files from the California state archives and the California Franchise Tax Board detailing legislative decision-making, and economic data on California's foreign trade and investment and tax collection system. Material was downloaded from Lexis on the U.S. Supreme Court 1993 Barclays/Colgate-Palmolive case, including the amicus curaie (friend of the court) briefs for both sides of the argument. A survey was made of the Organisation for Economic Cooperation and Development and United Nations standards on transfer pricing and unitary taxation.

A search was conducted of all relevant news articles and primary material on the debate over California's unitary tax to gain a fundamental understanding of the different arguments put forth and how the issue developed. All of the documents surveyed were then analysed to identify relevant actors active in the debate. Interviews were obtained by writing letters to the persons identified by the news search, and each participant was asked to identify other key players in the debate to ensure that the case study did not miss important players who had not been quoted in the press, or who had changed jobs since the time of the legislation. Interviews were conducted in Washington DC and New York City; in Sacramento and Los Angeles, California, and in London, England. In total, 52 interviews

were conducted. To ensure as much reliability in the data as possible, every effort was made to cross-reference opinions, and each individual's experience of the negotiating process was examined in the light of their position on the issue and their place within the negotiating hierarchy.[74]

Simultaneously, an extensive review of the academic literature was conducted to provide a solid base for theory and policy analysis. This literature was drawn from the disciplines of paradiplomacy[75]; federalism[76]; U.S. state political culture[77]; state-firm bargaining theory[78] and bargaining methodology[79]; political economy, particularly interdependence[80], the political economy of California,[81] and work on multinational enterprises[82]; and taxation theory[83], particularly transfer pricing practices[84], U.S. state corporate tax and fiscal policy[85], federalism in taxation[86], and unitary apportionment.[87] Material drawn from these various disciplines was used to analyse the debate which took place over California's unitary tax and to begin the tentative process of building a model of state-firm bargaining at the subfederal level.[88]

6) Core questions and hypotheses

The question of state-firm bargaining over U.S. subfederal economic policies in the international arena is of key importance to the field of international political economy. With the growth of international economic transactions, the increased intermingling of countries' domestic and foreign policies mandate a closer examination of international relations at the subfederal level. U.S. states have a significant ability to negotiate with multinational enterprises over their economic policies, control relatively large economies on an international basis, and are in command of large portions of the U.S. regulatory framework. The growth of international trade and investment in the U.S. means subfederal economic regulations increasingly have worldwide repercussions.

At the same time, the increased globalisation of economic activity has furthered attempts to codify international norms which govern trade and investment. These norms increasingly apply their reach to subfederal jurisdictions, and to the coverage of services and non-tariff barriers to trade, areas largely under the jurisdiction of states in the U.S. When

analysing state-firm bargaining over international economic rules, negotiations over U.S. subfederal regulations are a vital area of concern.

What happens when U.S. state economic regulations conflict with international norms? What capabilities do U.S. states possess to defend their regulations when bargaining in the international arena?

This thesis will argue that in the case of California's unitary tax, the following hypotheses are valid:

1) Powerful U.S. states such as California can maintain regulatory standards at odds with federal and international norms. Growing global economic interdependence is not eliminating California's regulatory options, since the U.S. federal government often refuses to effectively constrain powerful states which violate federal and international norms.

3) U.S. state governments can bargain directly with foreign governments and multinational enterprises as actors in the international arena. As the international arena increasingly intrudes on the affairs of subfederal governments, the U.S. federal government will not always be the preeminent negotiating channel for international actors seeking to influence U.S. economic policies.

7) Structure of the thesis

This thesis will examine the debate over California's use of the unitary tax method with a view to modeling the negotiations over U.S. state economic policies which violate international norms. It will do this by:

1) examining how debates over international taxation policy affected the debate over California's use of the worldwide unitary tax method. Chapter Two will describe what transfer pricing is, how it can be manipulated by MNEs, and the international arm's length standard for regulating transfer prices. It will describe the alternative formulary

apportionment and unitary methods of policing transfer pricing, and criticisms of the various methods. This chapter will demonstrate that the international regime governing the taxation of MNEs is mired in controversy, and that the lack of consensus over international tax norms heightened the debate over California's use of the unitary method.

2) identifying the actors in U.S. subfederal tax policy. Chapter Three will provide an overview of the players involved in lobbying on state tax issues in the U.S., particularly those who took part in the debate over California's unitary method. It will describe each actor's role in influencing U.S. state tax policy, its policy agenda on subfederal tax issues in general and with regards to the unitary method, and the political and economic assets that it had at its disposal. It will thus describe the first three components of the model being built to evaluate state-firm bargaining at the subfederal level: the actors, their agendas, and their assets. Chapter Three will also provide a broad overview of the legal issues involved in U.S. state action in the international arena in order to more fully define the parameters within which U.S. subfederal actors operate.

3) describing the political economy of the state of California, a lead actor in the debate over subfederal use of the unitary tax method. Chapter Four will describe the political structure of the California state government, the state's corporate tax authorities, the legislative committees which oversee state tax regulations, and the state institutions which implement California's international agenda. Further, it will describe California's economy, its economic culture, and its foreign trade and investment. Chapter Four will then describe California's particular political and economic assets. It will conclude by describing California-based lobbying groups which attempted to influence the debate over the state's unitary method.

4) presenting a factual case study of the debate over California's unitary tax method in Chapter Five. This chapter will include a history of California and federal laws concerning the unitary tax method, lobbying to change the method, and U.S. court cases which ruled on the legality of state use of the method. Chapter Five will provide a detailed examination of the extent of each actor's involvement in the negotiations,

collecting data on the relationships between various governments and MNEs in the debate over a subfederal economic policy which violated international norms.

5) analysing the case study to interpret the outcomes of the debate. Chapter Six will complete the model of state-firm bargaining over a subfederal economic policy which conflicted with international norms by i) evaluating how the various actors used, or failed to use, their political and economic assets to achieve their policy agendas; ii) evaluating how effectively the actors used various channels of negotiation to influence California's policy; and iii) examining key initiatives, highly effective uses of assets and negotiating channels which influenced the outcome of the policy debate. Chapter Six will therefore be the core analytical chapter of the thesis, assessing which strategies were successful when actors engaged in bargaining over a U.S. subfederal economic policy which violated international norms.

6) summarising the paper's conclusions in Chapter Seven. This chapter will demonstrate that the thesis has proved the hypotheses put forth in Chapter One and describe findings from the analysis of the debate. It will examine other clashes between international norms and U.S. state policies, describe subfederal activism in other countries, and discuss the possible implications of new multilateral agreements on U.S. subfederal economic regulations. The final chapter will finish by speculating on how conclusions drawn from analysis of California's unitary tax debate could apply to future negotiations over U.S. state economic policies which conflict with international norms.

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[1] "Among many areas of shared or overlapping powers in U.S. federalism, the federal government's constitutional and practical dominance in foreign affairs often stands out as a clearly defined exception" (John Kline, 1999, p. 112). Article 1, Section 8 of the U.S. Constitution gives the president the right to make treaties and Congress the right to regulate commerce and declare war. Indeed, it is often pointed out that the U.S. Constitution was created to correct the chaotic economic conditions the Articles of Confederation had spawned by asserting federal rights to regulate interstate commerce and international economic relations.

[2] Tolchin, 1988.

[3] Examples included U.S. states stipulating English as the only "official" language of the U.S.; discriminating against foreign suppliers in government procurement; excluding

foreigners from owning banks, insurance companies, or farmland; and prohibiting state liquor houses from selling Russian vodka (Fry, 1990). Further examples include city declarations of nuclear-free zones, U.S. localities providing sanctuary for illegal immigrants, the exchange of state trade missions with Libya despite U.S. trade controls, the refusal of airport landing rights to a foreign minister of the former Soviet Union, the promotion of sister-city relationships that provided assistance to Nicaragua when U.S. foreign policy supported that government's overthrow, the formulation of business practices principles (the "MacBride Principles") adopted by seventeen states and 40 municipalities for companies to observe to prevent religious discrimination in Northern Ireland, and several states' refusals to send their National Guard units for training in Honduras, after being ordered to do so by the U.S. federal government (subsequently overturned by congressional and Supreme Court action). More recently, states and localities have debated sanctioning nations accused of human rights violations, but, with the exception of Massachusetts state sanctions on companies doing business in Burma, only U.S. cities have implemented these measures (Kline, 1999, p. 114). See Appendix 4 for a list of current and pending U.S. subfederal economic sanctions.

[4] Kincaid, 1990.

[5] See Appendix 5.

[6] Stopford and Strange, 1991.

[7] See Chapter Three for a discussion of U.S. federalism and Chapter Four for a discussion of California's political economy.

[8] Scheiber (1993) and Rosenau (1997) examine how globalisation and technological changes have subjected nation-states to new pressures in their domestic affairs.

[9] Keohane & Nye (1989), Katzenstein (1978), and Gourevitch (1986).

[10] Brown, Fry, and Groen, 1993.

[11] Soldatos, 1990, p. 34.

[12] Kline, 1993, p. 203.

[13] Scheiber, 1993, p. 70-71.

[14] Archer and Morici, 1993; Kline, 1993, 1999; Scheiber, 1993; Soldatos 1993.

[15] Kline, 1993, p. 226.

[16] Soldatos, 1993, p. 45.

[17] Kline, 1993, p. 204.

[18] Ibid.

[19] Fry, 1993, p. 212.

[20] Archer and Morici, 1993, p. 186.

[21] Fry, 1993, p. 188.

[22] Ibid., p. 190.

[23] Kline, 1993, p. 226.

[24] Ibid., p. 226.

[25] Scheiber, 1993, p. 70.

[26] Hocking, 1992, p. 130.

[27] Fry, 1998, p. 5.

[28] Kline, 1999, p. 113.

[29] See also Appendix 4 for a list of current and pending U.S. subfederal economic sanctions.

[30] Braithwaite and Drahos, 2002, p 581.

[31] Ibid., p. 583.

[32] Ibid., p. 579.
[33] Ibid., p. 483.
[34] Ibid., p. 594.
[35] Fry, 1990.
[36] Duchacek, 1990, p. 3.
[37] Fry, 1990, p. 280.
[38] Robinson, 1983, p. 111.
[39] Picciotto, 1996/97, p. 10459-20.
[40] Duchacek, 1990, p. 16.
[41] Kincaid, 1990, p. 71.
[42] Ibid., p. 64.
[43] Fry, 1988, second citation; Kline, 1983.
[44] Soldatos, 1993, p. 46.
[45] Soldatos, 1990, 1993.
[46] Keating, 1999, p. 11.
[47] Latouche, 1988, p. 31.
[48] Soldatos, 1990, p. 49.
[49] Duchacek, 1990, p. 16.
[50] Hocking, 1992, p. 36.
[51] Ibid., p. 2, 3.
[52] Ibid., p. 24.
[53] Milner (1987, 1988, 1989).
[54] Stopford and Strange, 1991.
[55] Behrman, Boddewyn and Kapoor, 1975, p. 15.
[56] Hocking, 1999, p. 21.
[57] Ibid., 1999, p. 21.
[58] Hocking, 1999, p. 20.
[59] Kline, 1999, p. 134.
[60] Latouche, 1988, p. 34.
[61] Behrman, Boddewyn and Kapoor, 1975, p. 8.
[62] Ibid., p. 8.
[63] Ibid., p. 9.
[64] Hocking, 1999, p. 29.
[65] Ibid., p. 99.
[66] Ibid.
[67] Behrman, Boddewyn and Kapoor, 1975, p. 119.
[68] Keohane and Nye, 1989, p. 11.
[69] Ibid., p. 53.
[70] Ibid., p. 11.
[71] Ibid., p. 19. Strange, 1975, p. 219.
[72] Keohane and Nye, 1989, p. 21.
[73] Dahl, 1963, p. 52.
[74] See Appendix 18 for a list of interviewees.
[75] Aldecoa & Keating; Berkley & Fox; Brown & Fry; Brown, Fry & Groen; Duchacek; Fry; Hocking; Keating, Kincaid; Kline; Latouche; Michelmann & Soldatos; Scheiber; Shuman; Soldatos.
[76] Bakvis & Chandler; Brown-John; Caputo; Cerny; Earle; Livingston; O'Toole; Stepan.

[77] Eisinger; Elazar; Ely; Erickson, McIver & Wright; Gold.
[78] Behrman, Boddewyn & Kapoor; Behrman & Grosse; Encarnation & Wells; Fagre & Wells; Stopford & Strange; Strange.
[79] Ikle; Kapoor; Raiffa; Rangarajan.
[80] Gourevitch; Katzenstein; Keohane & Nye; Khan; Linklater & MacMillan; Rosenau.
[81] Cahn, Shockman & Shafie; Chapman; Dardia & Luck; DeBow & Syer; Dertouzos & Dardia; Durrenberger; Goldsborough; Kotkin & Grabowicz; Owens, Constantini & Weschler.
[82] Alworth; Boddewyn; Casson; Caves; Gladwin & Walter; Lall; Mahini & Wells; Moran; Muchlinski; Poynter; Prahalad & Doz; Safarian; Sally; Stopford & Dunning; Vernon.
[83] Giovannini; Hubbard & Slemrod; Hufbauer; McDaniel & Ault; Tanzi.
[84] Lall; Plasschaert; Vaitsos.
[85] Hartman; Hellerstein; Hellerstein & Hellerstein.
[86] Mansfield; Shaviro.
[87] Carlson & Galper; Friedhelm; McLure.
[88] See Appendix 7 for an unabridged account of the research approach.

Chapter 2: Defining the Problem: Taxation of MNEs

1) Introduction

This chapter will examine how debates over the proper means of governing the taxation of multinational enterprises (MNEs) affected state-firm bargaining over California's use of the worldwide combined unitary tax method, a method which conflicted with both federal and international tax norms. As we shall see, international tax norms are mired in controversy, and the lack of a consensus on international taxation standards fanned the flames of the debate over subfederal use of a controversial tax method. The debate over how best to tax MNEs is emblematic of the type of bargaining taking place between states and firms over the distribution of the benefits of international trade and investment. The debate over California's tax method was complicated by the wide variety between different national tax regulations, priorities, and enforcement capabilities. At the same time, the U.S. federal and state governments practice very different methods of assessing a company's taxable resources. These different methods could lead to conflict, since the U.S. states' sovereign powers of taxation are often unrestrained by contravening federal law.[1]

This chapter will support the hypothesis put forth in Chapter One that, even in an era of mobile capital, powerful U.S. states such as California are able to maintain regulatory standards at odds with federal and international norms: California's unitary tax method differed from both U.S. national policy and America's bilateral international tax agreements. This chapter also provides support to the hypothesis that international forces do not always have their primary policy impact at the national level: the debate over California's state tax method was directly impacted by the larger policy debate among international tax bodies over the correct method of taxing companies which do business across different national jurisdictions.

This chapter will describe the theoretical issues which lay behind the debate over international tax norms, and how California's use of the worldwide combined unitary tax method fit into this debate. It will explain the international norm used for evaluating the prices of the intrafirm trade of an MNE across national jurisdictions, the arm's length standard (ALS). It will describe what formulary apportionment and unitary taxation methods are and how they function to combat tax avoidance by MNEs which can manipulate the prices they charge on their intrafirm trade when using the ALS. It will then describe the economic theories supporting the arm's length standard and the various formulary apportionment methods, along with criticisms of these different methods.

2) Issues in international taxation

It has proved difficult to create international standards for taxation beyond a very general level. There is no unifying tax principle that compares to 'free trade', and there is no international mandate for tax reform. Vernon states that "as long as no international rules exist on the allocation of costs and income, the tax decisions of any national authority accordingly must be arbitrary".[2] While most countries' goal in international taxation was formerly to ensure equitable treatment from foreign countries for their national enterprises abroad, starting in the 1960s, the U.S. has led the way in focusing on collecting more tax revenue from MNEs.[3] MNE tax revenue has become a growing source of government revenue, and, correspondingly, a growing source of international tension as countries effectively fight over the profits of MNEs.

Tax harmonisation would be one way to avoid this conflict. However, most countries do not have tax systems which are easily comparable across national borders, and most have strong reasons to maintain their current tax structures. Tax regulations are produced by various national historical precedents, and diverse political, administrative, and ideological considerations. Moreover, governments have different public spending needs, and tax efficiency may have to take a backseat to revenue considerations. Strange, Milward, Milner, Tanzi, and Baldwin note that it is unrealistic to expect a country not to

take pressures besides economic efficiency into account when formulating economic policies.

Most national systems of taxation were developed in predominantly closed economies, and these systems have remained largely intact despite an enormous increase in capital movements across national borders. National tax regulations thus assume their tax subjects are predominantly individual or corporate citizens and, based on the principle of territoriality, that they have the right to tax the activities taking place within their given geographic jurisdiction in order to raise revenue for government spending which benefits the jurisdiction.[4] There is a "traditional, or historical assumption that much of the income of the taxpayers originates from within the jurisdiction and thus benefits from the expenditure by the government".[5] Higher taxes can mean better infrastructure, a more educated workforce, or other benefits which may be valued by citizens at a higher level than any revenue losses from taxation. However, the activities of multinational enterprises go beyond the territorial boundaries of the state, thus exceeding the traditional boundaries of tax regimes. There is thus a disjuncture between where corporations reside and where they conduct their economic activity.

Increased international economic integration may constrain a government's choice of tax structures or tax rates and erode a country's capital income tax base since "(i)nternationally mobile factors of production....can more easily avoid taxes levied in particular countries".[6] Although the ability of businesses to avoid onerous national tax systems can be seen as a healthy part of global economic integration, the potential degradation of their tax bases is obviously of great concern to national governments. In addition, MNE tax avoidance can adversely affect global economic efficiency, since the allocation of capital will be less efficient to the extent that it is driven by considerations other than pretax rates of return, such as avoiding high tax rates in a particular jurisdiction.[7] There is thus "a friction between an institutional, legal and administrative structure which is tied to the principle of territoriality and economic activities that more and more are losing a national or territorial character".[8]

In an effort to conquer this friction, there are two general approaches used as international norms in the taxation of multinational enterprises:

i) Source of income

Under this system, anyone who generates income within a jurisdiction is taxed by its authorities on the basis that the foreign subsidiary profits "arise, or have their 'source', within the host's territory".[9] Therefore, all foreign subsidiaries hosted within a jurisdiction are considered taxable, but the overseas subsidiaries of the home country's MNEs are not taxed. Countries which follow the source principle, such as Canada and Germany, exempt what their MNEs earn abroad from their national tax base. This system raises the possibility of double taxation if a host country uses source taxation and a home country uses the residence principle.

However, in practice, bilateral tax treaties between countries create a system of tax credits or deductions which can eliminate the possibility of double taxation. Under a tax credit scheme, the home country taxes its MNEs but gives credit for the taxes they have already paid abroad. The effective tax rate is then that of the home country, since the MNE "as a whole will have been subjected only to the host state rate of tax".[10] If the foreign tax rate is higher, in practice a home country will not rebate the foreign tax liability to its MNEs. However, the company is still protected from having the same income flow taxed by both the home and host state,[11] although the home state may still tax the distribution of foreign profits when they are remitted to the parent corporation as a dividend to its shareholders in the home state. The Netherlands, Belgium, France, and Switzerland use this method, which has been criticised as encouraging foreign investment in low-tax countries and the use of tax havens.[12]

Credit with deferral. This system allows for arbitrage due to delays in tax credit: MNE subsidiaries can pay the foreign tax rate on current profits, reinvest the balance in a third country, and earn income on the excess profits until they are repatriated. Credit deferral violates capital export neutrality by encouraging too much overseas investment if home-country tax rates are higher than host-country rates.

Credit without deferral. Alworth states that the credit system without deferral is the only truly neutral tax system and under it, firms have no incentive to manipulate transfer prices.

In a deduction system, home countries allow taxes paid by MNEs to be deducted from the income base that the home country taxes. For example, if the host country's tax rate was 30% and the home country's was 50%, the MNE would pay an overall tax rate of 65%. This means the MNE is subject to double taxation and neither capital export nor import neutrality will occur.

ii) Residence of taxpayer

Under this approach, a country taxes all of the income belonging to its citizens, both corporate and individual, resident in the taxing jurisdiction, no matter where that income is generated. This follows the territorial principle of tax jurisdictions. Money earned by overseas subsidiaries and remitted to parent companies which reside in the jurisdiction is taxable as part of the total income of the parent company, which the home state has jurisdiction over since the parent company is resident in the home country. In practice, countries which follow this approach (Japan, the U.S., and the UK) usually offer companies a credit, deduction, or exemption for income taxes already paid abroad, as described above. However, if the host country tax rate exceeds that of the home country, there will be excess foreign tax credits which are not refunded. The residence principle is usually only applied upon the repatriation of income, which allows a period of arbitrage while an affiliate has earned income but has not yet been required to repatriate it to pay a yearly income tax. This gives MNEs ruled by the residence principle an incentive to classify as much of their income as possible as foreign-sourced. The global integration of economies has reduced the effectiveness of the residence principle, as companies can more easily defer tax payments to their home countries, utilise overseas tax havens, and seek to weaken the flow of information on their increasingly large overseas activities to their home countries.

The Organisation for Economic Cooperation and Development (OECD), whose membership consists predominantly of developed, capital-exporting nations with many resident MNEs they can tax, supports the residence principle, fearing source-based methods of taxation will be used to minimise the repatriation of MNE profits. In contrast, the United Nations (UN), whose membership consists predominantly of capital-importing countries, questions the validity of capital flowing primarily in one direction under the residence principle. They view the residence principle as exploitive, since countries which are recipients of MNE investment see the transfer of profits made from their resources outside of their tax jurisdiction. The UN therefore favours the source-based method of taxing MNEs.

3) Transfer pricing

True multinational enterprises often trade in components as well as finished products, creating an international system of production within their own company. When transactions take place across national borders, even if they are internal transactions between different sections of a multinational firm, the company must set a price on them. Countries require prices on all goods crossing their borders in order to levy tariffs and income taxes; in addition, countries usually maintain accounting standards and legal requirements which require separate national profit-and-loss accounts. MNEs also often use separate national accounts to evaluate the relative profitability of their different national units.

The pricing of transfers between different units of an MNE does not take place according to traditional economic theories: it cannot be assumed that each actor's objective is to maximise profit at the other's expense, since both parties belong to the same ultimate concern. Both actors are trying to maximise joint profits, and price is merely being used as an accounting device. Transfer pricing thus introduces a divergence between the quantities of goods involved in intrafirm trade and their stated value, making comparative cost doctrines inapplicable. However, conventional trade theory does not distinguish between intrafirm and interfirm trade. The normative implications are intense:

if profit is distributed differently from the predictions of conventional economic theory, there will be correspondingly wide differences in the net gains of trade.

a) Which firms use transfer pricing

The propensities of different industries to use intrafirm rather than open market trade vary widely. Several surveys have tried to account for these variances by singling out the economic factors which contribute to intrafirm trade. Most researchers have found "intrafirm trade to increase with the parent's research intensity, presumably indicating the parent's disincentive either to decentralise production of innovative goods...or to trade them at arm's length".[13] 'Intangible' goods, which contain properties based on information, will often only be traded within firms, since information can be more easily copied if it is traded openly. Lall determined that intrafirm trade in intangible goods is most likely to occur in industries with a high level of technology and marketing requirements.[14] Goldsbrough notes that intrafirm trade is likely to involve more distinctive and less substitutable goods than those traded at arm's length.[15]

There can be many other reasons for a large level of intrafirm trade. Lall lists requirements for sophisticated after-sales service, aggressive promotion of a brand-name, the specificity of the product traded, the need for close coordination of marketing and production, specialised distribution networks, utilisation of unexploited capacity or scale economies, small or unstable markets, and the risk of price or quality variations in local supplies. Low advertising costs can also be an indicator of a large amount of intrafirm trade since firms may not be able to rely on their brand-name for marketing, instead needing to service overseas markets directly. Lall further states that an MNE with large assets overseas will be encouraged to trade internally across national borders to minimise country risk and exploit its relatively lower cost of collecting market information. However, Zejan found that MNEs with substantial host-country production do not use their parent companies to service local markets since scale economies can deter decentralised production.[16]

While it is generally agreed that MNE intrafirm trade as a percentage of total trade varies widely according to industry, some theorists postulate differences based on nationality. Lall states that because transfer pricing requires a high degree of centralisation to coordinate prices, firms with different nationalities, histories, or control and accounting structures may have different 'styles' of intrafirm trade. Vaitsos' theory that MNEs from small countries depend more on intrafirm trade to recoup fixed expenditures at headquarters, while seminal, has not been conclusively supported. More recently, Encarnation states that since an MNE's ownership structure, trading propensities, sectoral distribution, and industrial organisation vary across nationalities, a firm's nationality could lead to a preference for intracompany shipments vs. arm's length trade.[17] For example, Japanese MNEs use far more intra-company trade than U.S. MNEs. Encarnation feels this type of difference may lessen as MNEs become more internationalised and adjust to their host environments.

Given different levels of internal trade across firms, Lall states that the potential for manipulation of transfer pricing is highest when a product is not generally traded on the open market and has a high level of technology, and the MNE producing it conducts a great deal of intrafirm trade and holds a monopoly in pricing the product on the open market. Wilson states that the ability to flexibly set transfer prices is related both to high gross margins and the firm's ability to decouple activities in its production value chain.[18] These characteristics can all reinforce each other. Most surveys done on transfer pricing manipulation have focused on large firms in technologically-intense industries, where it is accepted that firms overcharge subsidiaries for intermediate goods to recoup high research and development costs at headquarters. In these firms, the transfer price can represent the company's view of the right rate of return for risky innovation in an oligopolistic structure. As such, it may be almost impossible to define a transfer price which is objectively 'correct'.

b) Reasons for transfer price manipulation

The most obvious reason for an MNE to manipulate its transfer prices would be to adjust its profit levels across countries until all of the company's profits have been shifted

to the lowest-tax jurisdiction.[19] However, Vaitsos' seminal work on transfer pricing lists both profit and non-profit motivations for transfer price manipulation.[20] Profit motivation can go beyond lowering a year-end tax bill, since there is an opportunity cost associated with declared earnings. Transfer pricing allows money to be transferred wherever it is needed at the time, while remitted earnings can only be transferred at the end of the fiscal year. Transfer price manipulation can make funds quickly available for investment in more profitable locales: this is especially useful when a firm is confronting continuous inflation and/or periodic adjustments in exchange rates, or any other high opportunity cost associated with keeping funds tied up in a host country.

Several business strategies can encourage transfer price manipulation: by affecting the cashflow of a subsidiary, altered transfer prices can help a unit meet liquidity requirements, which can affect its access to loans or meet local shareholder pressure for profits. Transfer price manipulation can also help an MNE maintain a monopolistic technological advantage, since a vertically integrated firm can declare returns wherever it has a technological advantage over competitors; the firm can then leverage this advantage and gain market share by undercharging on its products in select markets.

MNE motivation to manipulate transfer prices can occur when a host country has high tariffs, subsidies, or antidumping duties, multiple exchange rates for profit remittances vs. capital imports, or quantitative restrictions on profit remittances.[21] Transfer price manipulation can minimise risk by lowering profits in countries which have long-term balance of payment or exchange rate problems, political or social pressures, price controls, or a high rate of expropriation. These conditions frequently apply in developing countries, and transfer price manipulation often surrounds investments in less-developed countries (LDCs). Further, underdeclared subsidiary returns can avoid the appearance of LDC exploitation and lower a subsidiary's risk of either nationalisation or increased competition.[22]

Of course, these goals can be accomplished through other means than simply changing the prices on transferred goods, and these other means are generally also lumped

under the heading of 'transfer price manipulation'. Companies can reduce profits in a country by financing investments through loans instead of equity. These are issues of 'thin capitalisation' or 'earnings stripping', where the local company shows lower profits because of limited equity capital. Instead of receiving dividend payments from a heavily indebted subsidiary, the parent receives tax-deductible interest payments; debt is also more often honored when companies are nationalised. In addition, MNEs can shift profits across national borders through their discretionary power to allocate fixed costs (research, advertising, and general management overhead) and to determine royalty charges for using brand-names and patents. Vaitsos postulates that firms may divide global overhead among their affiliates by transferring an excessive amount of affiliate profit back to the parent company to cover headquarter operations.

c) Limits on transfer price manipulation

Limits on transfer price manipulation can be internal: manipulating prices requires a great deal of intra-firm centralisation, communication, information processing, and the capacity to persuade subsidiaries to implement a transfer pricing system which may undermine their profits. There is often a large internal cost associated with determining and implementing a transfer pricing system to achieve certain goals, and firms that gain only on the margin from manipulation may choose not to fiddle transfer prices if these costs outweigh or equal gains. Lall argues that large MNEs which have superior administrative ability and knowledge of world conditions tend to centralise management, and are therefore more likely to be able to effectively manipulate their transfer prices. Some theorists have speculated that the problems associated with requiring subsidiaries to under declare profits, including lowered motivation of unit managers and difficulty in determining a subsidiary's true profit, will prevent excess transfer pricing manipulation. However, it does not seem difficult in practice for an MNE to maintain two sets of accounts or use a supplemental evaluation method in conjunction with profit and loss accounts.[23]

The other limit to transfer price manipulation is, of course, government regulation. Here, customs and tax officials may be working at cross purposes: customs departments

want goods valued as highly as possible, while tax departments want incoming goods priced as low as possible to increase taxable profits. Greater interdepartmental coordination may be needed to ensure regulation is effective for the country as a whole.

The past two decades have seen a tightening of government regulations regarding transfer pricing practices, along with the development of international standards under the aegis of the United Nations and the Organisation for Economic Cooperation and Development. With the growth of external pressures, firms may increase self-regulation of their transfer pricing in an attempt to pre-empt government penalties. However, Alworth argues that transfer price manipulation may have grown even larger over the past twenty years with the rising absolute value of intracompany trades, the increased instability of exchange rates, and the growing sophistication of MNE tax planning strategies, which have increased apace with government controls.[24]

4) The arm's length standard

a) Definition

The Organisation for Economic Cooperation and Development and the United Nations, along with the U.S. federal government and most bilateral national income tax treaties, rely on the arm's length standard (ALS) to judge transactions across national borders between related parties. Therefore, the ALS is considered by many to be the international norm for taxing internal company transactions across national boundaries. The ALS standard judges the correct transfer price between associated companies to be the price which would apply if the companies were not related. The different sections of an MNE are therefore judged to be using price as if they were at 'arm's length' from each other. The ALS is also referred to as 'separate accounting', since it attempts to treat related company transactions as if they were being made by separate, distinct firms. As such, "the ALS is a classic example of attempting to limit jurisdictional scope (reach of tax powers) on territorial lines".[25] There are several different methods used to determine an arm's length price.

i) Comparable unrelated price (CUP)

The most direct way to compute an arm's length price is to find a comparable transaction between an unrelated buyer and seller and use it as a reference price.[26] This is based on the theory that unassociated enterprises operate in competitive conditions and that the competitive price, driven by market conditions of supply and demand, is the correct one. The method's primary attraction is that it is easy to apply and straightforward. However, it is also seen as the most unreliable method of judging transfer prices.

It is often quite difficult to determine whether a market is truly competitive or not, and the arm's length price is not correct unless the good being judged is sold in a competitive market. In addition, companies which become multinationals are often monopolies or oligopolies which have the market power to purchase goods at lower prices than their competitors. They may be able to segment markets in different countries, so that the market price for their product varies between countries, leading to confusion over which market should be used to find a comparable price.[27] Companies may also be able to confuse authorities by using third-party sales to create artificial prices. Moreover, an integrated firm is able to save on costs, and this is not reflected in market prices.

As well, intermediate goods are often not traded on the open market because they are goods used by only one company ('specific goods'). The arm's length standard is especially problematic with intangible goods: knowledge or marketing expertise which often has no market price due to the risk that it will be copied if it is traded on the open market. In addition, it can be difficult to find a truly comparable transaction. Even if another company's transactions look quite similar, each company has different levels of risk that it deems acceptable, and each MNE unit performs slightly different functions from others in its sector. In the U.S., the Internal Revenue Service (IRS) can only use public companies as a basis for comparable prices, since these are the only firms whose financial records it can legally access. The IRS has tried, under section 7602 of the U.S. Internal Revenue Code, to use its "summons power" to gain voluntary information from non-listed companies, but without much success. Lall argues that the arm's length

standard should not use an open market reference price at all: the firm should simply state at what price it would be prepared to sell the good to an unrelated concern.

If the comparable unrelated price cannot be found, the correct arm's length price is essentially 'reconstructed' from scratch.

ii) Cost-plus

This method looks at the cost of manufacturing a product and adds an appropriate margin for distribution services. It is easiest to use this method if the costs of production are straightforward and easily determined: it is most often used to set transfer prices for manufacturing facilities, or where related parties have long-term buy and supply agreements. This method is not economically neutral since it can affect the firm's production and allocation decisions if returns to scale are not constant.

iii) Sales-minus

This method takes the final price at which the product would be sold to unrelated buyers and subtracts an appropriate margin for distribution services. It is most often used to set transfer prices for sales and distribution centers. Again, this method's effect on output depends on the degree of monopoly that an MNE holds. If the firm is competitive, its marginal costs will exceed the final price at which it sells its goods, and the reconstructed price will force the firm to substantially alter its production and allocation decisions if it is to remain in the market. Even if the firm is non-competitive, "the tax on profits will always reduce output because the tax base is no longer computed on profits alone".[28]

iv) 'Fourth' methods

This refers to any other method used to allocate an MNE's profit to arrive at a 'correct' transfer price. While this may sound arbitrary, in practice any of the methods listed can be arbitrary, and compromise methods often allow both governments and firms to avoid costly litigation: they are therefore widely used in practice. However, Alworth suggests that since firms often use 'fourth' methods to pre-empt government action and

associated penalties, they may be simply "window dressing" their accounts to "achieve the level of profitability expected by the authorities for firms of their type".[29]

v) Profit splitting

The 'fourth method' most often used is the profit split method, splits the product's total profit among the different parts of a corporation in proportion to the assets and activities each unit contributes, based on benchmark market rates of return for each factor of production. This is a functional analysis, and it is often used to determine the price of intangible goods, where there are frequently no comparable uncontrolled transactions. In addition, a profit split may more clearly show the true economic value of a transaction involving an intangible because intangibles gather income both by themselves and by enhancing the value of other assets.

Although profit splitting was criticised by the U.S. Court of Appeals as "an inherently imprecise method of allocation" whose "outcome may be largely determine by bargaining between the fiscal authorities and the tax-paying company",[30] the method was adopted by the U.S. IRS in the finalized 1994 amendments to Section 482 of the Internal Revenue Code. Further amendments in 1995 and 1996 still reflect the approach of the 1994 revisions relating to transfer of tangible and intangible property. In 1996, the IRS issued final regulations of cost sharing arrangements for income related to intangibles which imposed qualifications on the definition of controlled participants involved in a transaction: these regulations sought to ensure that each participant in a transaction stood to benefit, in a manner that could be reliably measured, from the use of intangibles it had helped develop by either exploitation of the intangibles or from transferring or licensing those intangibles to others.

b) Criticisms of the arm's length standard

This section describes criticisms brought against the international norm for judging transfer prices, the arm's length standard. The arm's length standard judges the intrafirm transfer price against the price the transaction would have had if it had taken place between unrelated parties. However, the prevalent theory explaining the existence

of multinational enterprises holds that MNEs exist to capture transaction-based cost advantages. MNE cost advantages occur when two entities in separate countries that are part of the same corporate structure trade with each other at a lower price than they could on the open market. There is therefore an inherent tension associated with the ALS since MNEs, by their very reason for existence, will not have arm's length prices for intrafirm transactions. Caves divides transaction-cost advantages into horizontally-integrated, vertically-integrated, and portfolio-based investments.[31]

Horizontally-integrated enterprises perform similar production functions in different countries. However, they transact with each other through commonalities such as marketing strategies, management direction, or common brand-names. All these goods fall under the category of 'intangibles'. Companies which gain cost advantages from intangibles guard them closely, and will typically only trade intangibles in other countries if they can control their use through an inter-firm structure, thus ensuring these intangibles remain under their corporate control. Horizontally-integrated firms tend to be those which rely heavily on intangibles such as patents, specific high-technology or managerial skills, or marketing and advertising (a 'brand-name' advantage). Casson and Teece also stress the intangible advantages MNEs can create through investments in technology and marketing which allow firms to differentiate their products and services from those of their competitors. Such firms are able to compete in areas besides price.[32]

Vertically-integrated enterprises integrate their production across countries, basing each stage of the production process in the country where it can be performed most efficiently. A vertically-integrated company gains benefits from keeping different parts of its production process spread among different countries under the same corporate structure. Open market economies can have high contracting and monitoring costs for transactions, particularly if a firm is highly reliant on certain goods. Presuppositions of competitive markets such as easily-obtained price information, frequent trades, and homogenous products with large numbers of buyers and sellers often do not hold in certain industries, particularly commodities. In the case of such market failures, long-term

alliances, exemplified by vertical integration, may be in all parties' best economic interest since they allow resources to be allocated without reliance on a faulty price mechanism.

Portfolio-based MNEs invest in different countries in order to diversify their business risk. Different political economies have different levels of systemic risk, and a company which is located in more than one economy can lower its overall exposure to market conditions, ensuring profit stability. Multinationals created to lower risk are known as 'diversified multinationals', and typically contain several different industries under one company umbrella. Although these MNEs, like the previous two types, extract benefits from investing abroad which cannot be captured in the marketplace, the benefits to portfolio-based investments do not come from their transactions, but from the nature of their diversified business.

If MNEs exist to capture gains that would not exist if their international transactions took place on the open market, the arm's length price will by definition not be the correct transfer price for an MNE. Furthermore, a continuum of 'correct' transfer prices exists within most industries, and there may be an automatic bias by both companies and tax authorities to push transfer prices towards a more favourable end of the scale. In addition, it can be difficult to determine exactly which tax jurisdiction is the source of MNE profits if a functionally integrated and interdependent MNE has spread its production between different countries.

Many argue that it is wishful thinking to believe there is an international norm on the correct method for taxing the internal transactions of an MNE across national borders: that there is no arm's length 'standard' and certainly no uniform application of such a standard, since different national tax authorities do not operate in similar ways and have not agreed on the definition or application of the ALS beyond very general terms.[33] National rules which follow the arm's length standard are "thus not neutral instruments of tax policy and may bring about non-negligible reallocations of resources".[34]

The arm's length standard is also criticised as being quite difficult to administer and requiring a large deployment of government resources. Full implementation of the method requires the collection of a large quantity of information on company activities, and the determination of which specific transactions are comparable.[35] Determining a fair and reasonable price for goods exchanged between related corporate entities is difficult, sometimes impossible, and the allocation of indirect expenses, such as advertising costs, among corporate entities can be based on arbitrary criteria.[36] Some companies may be reluctant to discharge even the basic information needed to make it possible to evaluate the arm's length standard properly. In practice, the U.S. Internal Revenue Service tends to reference industry standards or sectoral averages, which are more easily compiled than a list of specific comparable unrelated prices, especially for unique high-profit intangibles which do not exist in other firms.[37]

Governments with smaller resources protest that the cost and time of auditing tax returns under this method is considerable, and that their ensuing difficulty in monitoring arm's length prices will result in MNE tax evasion.[38] Opponents of the ALS contend that a true arm's length standard, which seeks a comparable unrelated price for every MNE transaction, is too complicated to administer, and that most countries do not even attempt to correctly administer it. They therefore feel that the ALS is a policy failure, and that the international "standard" has in fact become a free license for companies to declare the amount and location of their profits to their ultimate advantage.[39]

5) Formula apportionment

a) Definition

Formula apportionment is a response to the problems which critics of the ALS feel are inherent in finding an arm's length price. The philosophy behind this method is that it is basically impossible to construct a comparable arm's length price, and extremely difficult for government officials to monitor multijurisdictional accounts in order to verify that proper transfer prices have been used. Formula apportionment therefore disregards profit as the basis for taxation, and instead concentrates on taxing the resources which a

business uses to generate income, relying on a simple formula to compute how many resources a company uses in each tax jurisdiction. In its reliance on the underlying resources used to generate profit, it is similar to the 'profit splitting' methods used under the ALS. Formula apportionment is the standard way of taxing corporate income between states in the U.S., since it provides a simple means of dividing income across state lines. The standard formula apportionment approach is to tax equally-weighted proportions of payroll (as a measure of labour used), property (as a measure of capital used), and sales (to encompass the role of market demand in generating income). This is known as the 'Massachusetts formula' after the U.S. state which first employed it.

This method is an attempt, in a world of increased economic integration, to determine the taxable benefits a company derives from each tax jurisdiction in which it operates. It is, in effect, a shorthand approach to international taxation standards, simple to define and to apply, which seeks to avoid the pitfalls of the ALS method. As Weiner points out, "(p)resent systems that assign profits to a geographical location become obsolete when companies no longer operate within those geographical limits".[40] Use of a standard formula for judging the internal transactions of MNEs across national borders may eliminate differences between government tax codes which allow MNEs to manipulate their transfer prices between countries and avoid taxation. Formula apportionment also avoids the inherent contradiction, under the lowered transaction cost theory, of using an arm's length price to evaluate transactions between units of an MNE.

b) Unitary taxation

While non-unitary formula apportionment respects the legal limits of incorporation and excludes operations incorporated in other tax jurisdictions from the tax base, unitary taxation refers to the process whereby, before apportioning the firm's earnings by formula to different jurisdictions, the taxing body first gathers together the total activities of the enterprise in different jurisdictions. The different methods of unitary taxation are as follows:

i) worldwide combination gathers together the worldwide activities of any company connected with the taxing jurisdiction. This method therefore combines the resources of all affiliates remotely associated with a company doing business in the tax jurisdiction into the apportionable base, regardless of whether these affiliates are operating in other countries. It includes foreign parent companies and their worldwide foreign subsidiaries in the base.

ii) domestic worldwide combination is similar in that it combines all the affiliates of a company operating in the tax jurisdiction into the apportionable base, but this method excludes the foreign subsidiaries of any foreign-incorporated parent companies; it looks only at the worldwide activities of domestically-incorporated firms.

iii) domestic combination combines the domestic activities of domestic-incorporated companies operating in the taxing jurisdiction, but does not look at any of their overseas activities.

iv) water's edge combination ignores the nationality of a company: it gathers together all the domestic business activities of any company doing business in the tax jurisdiction, and excludes the resources of all overseas affiliates from the taxable base.

Formulary apportionment methods have been used by U.S. states since the 1930s to allocate the unitary income of multistate corporations, as more and more U.S. companies began to conduct business in more than one state. Since much U.S. multistate business is now conducted through subsidiary companies, many states have adopted a combined method of apportionment.[41] For example, although each of the 46 U.S. states that tax corporate income use formula apportionment, fewer than two-thirds of these states use combined, or unitary taxation.[42]

c) Criticisms of formula apportionment

This section of the chapter further describes the various problems associated with the use of formulary apportionment methods. Use of a standard international method for

evaluating transfer pricing is of key importance in avoiding the overtaxation, undertaxation, or double taxation of an MNE operating between different countries. If jurisdictions apply diverse standards and there is no overarching international tax authority to ensure their coordination, discrepancies are inevitable. Indeed, several theorists contend that the actual standard used to evaluate transfer prices is less important than the need for a uniform norm between countries.[43] Since use of the ALS is far more widespread, many argue its very predominance makes it a better international standard than formula apportionment.[44]

Even if formula apportionment is theoretically a better system, its widespread use as an international norm may not be workable in practice. On purely political grounds, the worldwide use of formula apportionment would create difficulties: countries would have to agree to standard definitions of a taxable income base, taxable factors of production, the apportionment formula itself, and the tax rate, and simultaneously convert their accounting systems to avoid an enhanced risk of double taxation from the inclusion of different components in each taxable factor of production. Since harmonisation of apportionment formulas is still incomplete between the U.S. states, it is difficult to imagine countries agreeing to harmonise their tax systems to the extent needed within a reasonable period of time.

The use of formula apportionment evolved within the United States as it became more difficult to divide economic activities by U.S. state boundaries, and accordingly more difficult for state tax authorities to verify their jurisdiction's income. This method was fairly easy to adopt in the U.S., where the states have no physical borders; share a common language, currency, tariff structure and integrated economic conditions; have similar accounting systems, laws, and effective tax rates; and, most importantly, are bound within a federal system of taxation which allows all states to access full corporate records for business activities within the U.S.

These criteria are not present at the international level. Variations in currency exchange rates can be a significant factor behind variations in profits or resource costs

across countries. In addition, apportionment does not account for cross-country variations in the rates of return to capital and labour due to risk differentials, imperfect capital markets, and various degrees of labour-capital intensity. This may make a worldwide standard formula using payroll, property and sales factors inaccurate, since it would allocate an unduly high proportion of income, and corresponding tax revenue, to developed countries where wage rates, property values and sales prices are higher. There is an argument, however, that higher costs for factors of production in developed countries are justified since their productivity is correspondingly higher, and that, in any case, MNE decision-makers would only use these more expensive factors of production if they were seen as advancing their business objectives, which include the maximisation of overall company profits.

Another prime objection to the use of formulary methods at the international level has been the burden of compliance. The technical problems associated with pooling standardised financial information about MNEs between countries with different accounting and legal systems are formidable. Different definitions of 'income' across both subnational and national lines (i.e., whether to include interest, dividends, royalties, capital gains, etc.) have proved troublesome. Efforts to obtain company information across national lines are often seen as infringements on jurisdictional sovereignty.

Foreign-domiciled business may encounter further problems. Many countries do not maintain historical cost data, making accurate computations of the property factor difficult; cultural differences may affect the relative ratio of wages to benefits, so that payrolls differ widely; and foreign laws regarding confidentiality may make it impossible to share financial information with overseas jurisdictions, especially with subfederal governments which do not hold bilateral treaties with secrecy provisions. MNEs argue they would have to recalculate their entire worldwide profits according to each set of local rules. When it is used by U.S. states, the burden of compliance for worldwide formula apportionment is considered to be heavier on foreign-domiciled corporations, since U.S.-domiciled MNEs normally prepare U.S. federal consolidated tax returns which incorporate their worldwide income in a standardised format.

When worldwide unitary formula apportionment is used in the U.S. at the subfederal level, MNEs further argue they must define their profits and the cost of their resources according to the different criteria applied in each U.S. state. They claim this imposes a heavy administration burden, particularly for foreign-domiciled MNEs, since U.S. state accounting principles must be applied to overseas subsidiaries which do not normally pay tax in the United States. At the same time, there is simply a "feel bad" factor associated with having to meet separate legal requirements for the subfederal level of a foreign government.[45]

However, jurisdictions which advocate the use of formula apportionment claim that compliance costs are not as prohibitive as companies insist since intergroup financial reports exist, MNEs already have to administer currency conversions to assess the relative profitability of subsidiaries in different countries, and most MNEs which borrow money in foreign countries or list subsidiaries on foreign stock markets have already converted their worldwide financial records to a standard format.

The OECD protests that formula apportionment methods are arbitrary and disregard market conditions, producing an allocation of profits which may have no real relationship to economic facts and inherently running the risk of allocating profits to an MNE which is actually losing money.[46] In addition, the OECD argues that tax jurisdictions often have too much discretion in determining what constitutes a unitary business.

At base, the problem with any formulary apportionment method is that it is at best only an approximation of what contributes to the profitability of a firm. A system with more accurate measurements will be proportionately more difficult to administer. In fact, proponents of formula apportionment have argued that, since any system of measurement is an approximation, the formula's simplicity and uniformity across jurisdictions is more important than its accuracy. They believe the separate accounting method is at least as arbitrary as formula apportionment.

d) Criticisms of worldwide combined unitary taxation

The worldwide combination unitary method (WWC) has been the most heavily criticised of all formula apportionment methods. Its opponents claim the WWC system taxes extraterritorial income by including foreign source income in its taxable base. The ALS is enshrined in most countries' laws and treaties, including U.S. federal laws and treaties, because it upholds separate accounting, which maintains the principle of jurisdictional sovereignty based on territoriality. If the host country of an MNE uses worldwide unitary taxation, it could end up taxing profits in the MNE's home country by including them in its apportionable income base. If the MNE home country uses the arm's length standard, the firm then risks paying tax to two jurisdictions on profits in its home country. Further, the system effectively credits WWC unitary jurisdictions with relatively higher profits earned elsewhere and subjects them to tax, while firms which make relatively higher profits within the WWC home jurisdiction are credited against losses elsewhere so that they pay fewer taxes. A WWC system thus rewards locally profitable firms at the expense of other taxing jurisdictions.

WWC supporters argue that in an international economy, national boundaries must, to a certain extent, be ignored. Unitary taxation developed within the United States when it becomes more and more difficult to define company activities as belonging to one state; proponents of the worldwide method argue WWC is simply a technical conclusion from supporting the use of formulary apportionment methods in an integrated global economy.[47] Others contend that MNEs are opposed to the WWC method because they fear its use by developing countries, where the ease of administering the method in comparison to the ALS makes WWC attractive. As developing countries become more integrated in the global economy, their potential use of a method which will increase their tax revenue, by including the higher-priced factors of production in developed countries in an MNE's apportionable income base, may be alarming to both MNEs and their home governments.[48]

e) The international regime for transfer pricing standards

No national governments have ever adopted worldwide unitary combination methods for taxing international income.[49] Although formula apportionment methods are source-based, even countries which follow the source principle, such as Germany, uphold the arm's length standard of judging interfirm prices across national boundaries. The use of formula apportionment for judging the transfer pricing practices of MNEs is accepted only at the subnational level of government, most notably by the U.S. states.[50] As such, the method is not explicitly eligible for tax credits under most bilateral treaties.[51]

The apportionment system was evaluated early on by the League of Nations as a means of harmonising the international taxation of foreign income and relieving the double taxation of MNEs by competing jurisdictions. However, a League committee reported in 1942 that variations in rates of return were likely to differ more between countries than between economically similar states within a federation.[52] Therefore, although apportionment was advantageous for use within a federal system, it was not advisable to use the system on an international basis. Instead, the use of separate accounting was recommended by both the League and the International Chamber of Commerce.

The Model Tax Treaty of the Organisation for Economic Cooperation and Development[53] rejects the apportionment approach, along with a 1974 United Nations report establishing treaty guidelines between developed and developing countries.[54] The OECD Model Treaty, which promotes the use of the arm's length standard, is the basis for most bilateral tax treaties between developed countries. The OECD has criticised the U.S. Internal Revenue Service for any departures from the arm's length approach as risking increased international double taxation by having two methods of judging transfer pricing practices at use in the international system.[55] The OECD instead prefers a transaction-based approach to judging transfer pricing practices.

Despite this codification of the ALS as the international norm for judging the internal transactions of MNEs across national boundaries, there is continued controversy

over the method's accuracy. This has particularly been the case in the U.S. Section 482 of the U.S. Internal Revenue Tax Code, passed in 1968, endorses the use of the arm's length standard, but the IRS has allowed companies to use, as a last resort, "other methods" of pricing, which could, in certain cases, include profit splitting: allocating profits between units based on a functional analysis of the contributions of various factors of production to a company's profit. Profit splitting's emphasis on taxing the contribution of the resources which a business uses to generate income has led many to call it, in essence, a formulary apportionment method. Section 482 was amended in 1986 to mandate that cases involving the transfer or licence of intangible goods follow a 'commensurate with income' standard.[56] This standard incorporates the profit splitting approach by examining "the relative economic contributions which each of the related parties involved has made to the income which has been generated".[57] U.S. states framed the 1986 amendment to Section 482 as an admission on the part of the federal government that the ALS was not working and that formulary apportionment methods were more accurate.

The U.S. Internal Revenue Service issued temporary regulations in 1993 which further appeared to accede to proponents of formulary apportionment methods by extending the 'commensurate with income' standard to transfers of tangible goods as well as intangible goods. This was done by introducing the possibility of using the comparable profit interval (CPI) method, which requires that transactions between related parties fall within the range of profits earned by unrelated parties. These regulations were criticised by the U.S. states as further proof that the ALS was a policy failure and formulary apportionment methods were more accurate; they were also criticised by the International Chamber of Commerce (ICC) Commission on Taxation as a departure from U.S. endorsement of the ALS as the only legitimate method for determining correct transfer prices.[58] The IRS temporary regulations were made permanent in 1994 and further updated in 1995 and 1996 with amendments which dealt with cost-sharing arrangements between related businesses.

Propelled by the debate over U.S. state use of the worldwide combined unitary method, the U.S. federal government led efforts to revitalise the ALS at the international

level by updating OECD transfer pricing principles which endorsed the ALS.[59] In April 1993, the OECD's Committee on Fiscal Affairs established a special task force to revise its 1979 transfer pricing standards and develop clear guidelines for the application of the arm's length standard. Members of the 1993 Task Force noted that comments they had received from the OECD's Business and Industry Advisory Council (BIAC), composed of leading MNEs, declared that the unitary approach presented intolerable compliance costs since companies were required to gather information about their entire worldwide business and present this information in accordance with each jurisdiction's particular accounting and tax regulations.[60] Companies would have to disregard their already agreed-upon commercial contracts and "apply artificial pricing rules based on hypothetical profits".[61] Moreover, MNE recordkeeping costs would balloon if the unitary approach was in use, since companies would still have to maintain records in accordance with the arm's length principle in order to comply with customs rules and accounting requirements. At the same time, the BIAC argued, the detailed tax information demanded would "often be unavailable and, as a result, the IRS would have to make subjective judgments about profit comparisons".[62] The BIAC argued that the proposed U.S. method would "increase double taxation to an unprecedented scale".[63]

Ironically, it proved difficult to get the U.S. government to agree to the revised OECD guidelines, since the IRS wanted the rules to include some discrepancy for their formulary apportionment-style profit splitting and comparable profit interval methods,[64] now incorporated as permanently available U.S. methods in the IRS' 1994 regulations. This resistance was criticised by European countries, who feared it demonstrated the U.S. was not fully committed to the arm's length standard.[65] Americans countered privately that the Europeans were only holding to the ALS without exception because they were not enforcing their transfer pricing regulations as strictly as the IRS.[66] In turn, the U.S. was criticised by other countries for applying the international standards too rigorously, and being out of sync with the other developed countries' more relaxed application of transfer pricing rules.[67] In the end, OECD regulations continued to firmly endorse the arm's length method of taxation and protest the use of formulary apportionment for international transactions except as a means of verifying an arm's length price when the countries

concerned agree that all other methods of evaluating an MNE's transfer prices pose insurmountable difficulties.[68]

6) Summary

This chapter has examined the different methods used to tax the profits from an MNE's internal transactions across national borders. As we have seen, consensus is not present on the 'rules of the game' in international taxation between the arm's length and formulary apportionment methods. Governance in the area of international tax policy is complex and fueled by a multilayered network of institutions[69] that compete as much as they coordinate and attempt to harmonize; subjecting international taxation to "a bewildering complexity of layers of interacting regulation".[70] Since transfer pricing policies are governed by "soft law principles, regulators need informality and confidentiality"[71] to retain the flexibility needed for reconciling the national and international levels of decision making and avoiding binding international arbitration. "Thus, tax officials have long been reluctant to accept a binding obligation with a right to international arbitration to avoid international 'double taxation,' through, for example, a mandatory 'corresponding adjustment' of transfer prices. They consider that such matters must be inherently discretionary, given the complexity of the issues and the interlocking nature of the policy interests involved".[72]

The lack of consensus over the proper means of regulating MNE transfer prices has led to conflicts between tax authorities, and between these authorities and the companies they tax. These conflicts are further exacerbated in the U.S. by differences between the U.S. federal government, a proponent of the arm's length method with modifications, and the U.S. states, which use formulary apportionment methods to tax companies operating within their jurisdiction. With the growth of international economic activity in U.S. states, the conflict between the U.S. federal and state governments over the correct method of evaluating the transfer pricing practices of MNEs has been exacerbated by foreign companies doing business in U.S. states whose home governments adhere to the arm's length standard and protest both the U.S. states' use of formulary

apportionment methods, particularly the worldwide combined method, and the U.S. federal government's own perceived departures from the ALS.

The growth of international economic transactions within U.S. state tax jurisdictions has therefore placed the states which use worldwide unitary taxation methods firmly within the international debate over the correct method of taxing the internal transactions of a multinational enterprise across different tax jurisdictions. International organisations and bilateral tax treaties, agreed to by the U.S. government, which enshrine the ALS heightened protests from MNEs over California's use of the WWC method, and led MNEs and their home governments into a series of negotiations and legal protests against both the U.S. federal government and the state of California. This chapter therefore provides support to the hypothesis in Chapter One that international forces do not always have their primary policy impact at the national level: the international arena is increasingly intruding on the policies of subfederal governments. In addition, the chapter provides support to the hypothesis that powerful U.S. states such as California can maintain regulatory standards which are at odds with federal and international norms, since California maintained unitary tax regulations which conflicted with both U.S. national tax policy and America's bilateral international tax agreements. As we shall see in the following chapter, California was not directly bound by U.S. federal laws and international agreements which promulgated the ALS method, and no enforceable international tax regime existed to curtail the state's use of formulary apportionment methods.

This chapter has described the international policy implications of California's use of the worldwide combined unitary tax method in the context of growing concern over the ability of multinational enterprises to practice tax evasion through manipulation of their transfer prices. The next chapter will provide an overview of the different actors involved in the debate over U.S. state use of formulary apportionment methods, focusing on the players involved in the negotiations over California's use of the worldwide combined unitary tax method. Through defining these actors, the thesis will begin the process of

modeling fixed dimensions to state-firm bargaining over U.S. subfederal economic policies which conflict with international norms such as the arm's length method.

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[1] See Chapter 3.
[2] Vernon, 1977, p. 125.
[3] Ibid.
[4] Tanzi, 1995, p. 68.
[5] Ibid.
[6] Ibid., p. 70.
[7] Ibid.
[8] Ibid.
[9] Muchlinski, 1995, p. 278.
[10] Ibid., p. 279.
[11] Ibid., p. 391.
[12] Ibid., p. 280.
[13] Caves, 1996, p. 33.
[14] Lall, 1980.
[15] Caves, 1996, p. 33.
[16] Ibid.
[17] Vaitsos, 1974; Encarnation,1993.
[18] Wilson, 1993.
[19] Caves, 1996, p. 193.
[20] Vaitsos, 1974.
[21] Lall, 1980.
[22] Ibid.
[23] Wilson, 1974, p. 277-307.
[24] Alworth, 1988.
[25] Picciotto, 1996/97, p. 1023-1027.
[26] Alworth, p. 220.
[27] Ibid.
[28] Ibid., p. 223.
[29] Ibid.
[30] *Eli Lilly & Co.* v. *CIR*. Plasschaert, 1979. At paragraph 1d1.7 in Chapter 10, Appendix 1.
[31] Caves, 1996.
[32] Stopford and Strange, 1991, p. 75.
[33] Interview #7.
[34] Alworth, 1988, p. 226.
[35] Interview #38.
[36] California Business Council, February 1985, p. 2.
[37] Interview #3.
[38] California Business Council, February 1985, p. 1.

[39] Interview #18.
[40] Weiner, 1994, p. 5.
[41] J. Dwight Evans, 1994, p. 4.
[42] Weiner, 1994.
[43] Interview #29.
[44] Interview #3.
[45] Interview #24.
[46] Redmond, 1981, p. 99.
[47] Interview #18.
[48] Interview #7.
[49] Weiner, 1994, p. 153. However, some national governments have incorporated unitary-type methods into their separate accounting regulations. See Appendix 17, Section 1.
[50] See Appendix 17, Section 2.
[51] Friedhelm, 1984, p. 104.
[52] Weiner, 1994, p. 177.
[53] 1963, 1977, 1992.
[54] Weiner, 1994, p. 177.
[55] Muchlinski, 1995, p. 294.
[56] Ibid., p. 291.
[57] McDaniel and Ault, 1989, p. 140.
[58] Muchlinski, 1995, p. 295.
[59] Interview #3.
[60] Hay, Horner and Owens, 1994, p. 513.
[61] Muchlinski, 1995, p. 294.
[62] Ibid.
[63] Ibid.
[64] Interview #3.
[65] Ibid.
[66] Interview #18.
[67] Interview #3.
[68] Hay, Horner and Owens, 1994, p. 519.
[69] Picciotto, 1996/97, p. 1021.
[70] Ibid., p. 1021.
[71] Picciotto, 1996/97, p. 10459-20.
[72] Ibid., p. 1049-1050.

Chapter 3: The Actors

1) Introduction

The increasing number of international economic interactions taking place within the U.S. has increased the number of actors influenced by U.S. state regulations. It is necessary to define the motivations and resources of the various actors operating within the U.S. subfederal arena in order to understand the diverse negotiations taking place over U.S. state economic policies with international implications. This thesis supports Hocking's view that actors at the subfederal level operate in a complex "multi-layered policy milieu" where various regulatory institutions compete and coordinate, preventing the dominance of any one actor.[1] This chapter will begin modeling fixed dimensions to state-firm bargaining at the subfederal level by examining the participants in the debate over California's unitary tax method.

Chapter Three will describe the role of various actors in the formulation of U.S. state tax policy, their policy agendas on subfederal tax issues in general and with regards to the unitary tax method, and the political and economic assets which each actor had at its disposal. It will thus describe the first three components of the model being built to evaluate state-firm bargaining at the subfederal level: the actors, their agendas, and their assets. Chapter Six will then complete the model of state-firm bargaining at the subfederal level by examining how effectively the actors outlined in this chapter used their assets to influence the debate over California's unitary tax policy. As a lead actor in the unitary tax debate, the state of California will be examined separately in Chapter Four; Chapter Five will provide a factual case study of the debate.

As defined in Chapter One, assets are resources which give an actor the potential to affect subfederal economic policies in a state-firm bargaining relationship. Political assets are those which allow an actor to influence policy directly, and include resources such as an actor's rights under a jurisdictional legal structure, access to key decision makers, hold over

popular opinion, or the ability to marshal support for a political leader who can formulate policy. Economic assets are defined as resources which allow an actor to indirectly influence subfederal economic regulations by the weight of their importance to the marketplace (such as access to proprietary technology, capital, key skills, natural resources, or markets). Both political and economic assets can give an actor power in the regulatory arena since other jurisdictions may model their legal systems in an attempt to gain access to their market. Possession of these political and economic assets gives actors the potential to affect the outcome of a policy debate: however, actual influence over the outcomes of a debate comes only from the successful conversion of these assets into influence through bargaining. This chapter will define the potential power that each actor possessed upon entering into negotiations over California's tax policy. Chapter Five will describe the policy debate; Chapter Six will then evaluate the successful conversion of these assets into influence on the policy debate.

Chapter Three will also provide a broad overview of the legal issues involved in U.S. state action in the international arena in order to more fully define the legal parameters within which U.S. state actors operate in the American federal system. This chapter will provide further support to the hypothesis that powerful U.S. states such as California can maintain regulatory standards at odds with federal and international norms, demonstrating that the nature of U.S. federalism limits a straightforward imposition of international or federal law on the economic regulations of powerful U.S. states with international implications. U.S. courts have not always used their power to overturn state laws which potentially conflict with federal regulations or international treaties, instead ruling that only congressional laws which specifically contradict state law can override state economic policies. This has resulted in increased lobbying of the U.S. Congress, which has proved reluctant to preempt state interests. The United States' accession to international economic policy agreements has been followed by broad exceptions for state policies in the federal legislation implementing these agreements into U.S. law. These weak constraints provide a broad legal arena for U.S. state regulations, within which various actors can seek to influence subfederal economic policies.

In addition, U.S. states have proved they can be adept at experimentally putting forth models of regulation in opposition to dominant international regulatory frameworks. As stated in Chapter One, persistent application of this strategy can eventually draw out contradictions in the dominant model, creating a minority constituency for the oppositional model.[2] In the case of international transfer pricing regulations, as shown in Chapter Two, California proved adept at putting forth the unitary tax model in opposition to the dominant arm's length standard (ALS) model and forcing the modification of the dominant model in the U.S. after the ALS was called into question by the international epistemic community of tax officials.

Further, this chapter will support the second hypothesis put forth in Chapter One, that U.S. state governments can bargain directly in the international arena. Examination of the legal issues surrounding U.S. subfederal action in the international arena will demonstrate that the U.S. federal government does not always asset itself as the preeminent negotiating channel for international actors which protest U.S. state economic regulations, nor is it allowed to by the U.S. judiciary. This acquiescence on the part of the federal government allows U.S. state governments to bargain directly with foreign governments and multinational enterprises as actors in the international arena.

2) Federal government

a) Actors

The Judiciary. The Supremacy Clause of the U.S. Constitution (Article 4) allows the courts to overrule any state law which conflicts with the U.S. Constitution, a federal law or a U.S. treaty. However, the Supreme Court has tried to reconcile state and federal laws, stating that "federal supremacy is not lightly to be presumed", and ruling many federal laws and policies ambiguous.[3] "Conflict between the taxing powers and revenue needs of the states and the requirements of a unified, national economy is inherent in the federal system...Each new means of production and transportation has generated commerce and due process clause controversy relative to the taxing power of the states".[4]

The Commerce Clause of the U.S. Constitution (Article 1, Section 8, clause 3) gives Congress the power to regulate interstate and foreign commerce, and the judiciary has the ability to overrule state laws which conflict with congressional laws on interstate or foreign commerce. Even if there is no specific law or treaty in place (if Congress has been dormant by not taking action to pass a law banning a state practice), if a state law interferes with the nation's commerce, U.S. case law had supported the right of the Supreme Court to rule the law an unconstitutional burden on the nation's commerce. This authority is known as the 'dormant commerce clause'.

However, the courts have not been aggressive in their use of the commerce clause to restrict state taxation of interstate and foreign commerce; instead, Supreme Court rulings have merely fixed the "outside limits of decency", allowing the states to tax interstate commerce if it does not create an undue burden such as multiple taxation.[5] There have been roughly three hundred U.S. court rulings on whether state tax measures are in accord with the commerce clause of the U.S. Constitution, resulting in a "quagmire" of decisions that are "not always clear, consistent or reconcilable".[6] The courts have ruled invalid state taxes on interstate or foreign commerce which conflict with specific federal legislation,[7] and which frustrate the purposes and objectives of federal legislation.[8]

However, cases where the courts have ruled state taxes illegal simply because they frustrate the policy intent behind congressional legislation are rare.[9] In addition, the Supreme Court has repeatedly upheld the constitutionality of combined unitary apportionment methods to determine the state's share of the income of the U.S.-domiciled multicompany group operating across several states.[10] Unless Congress explicitly exercises its legislative power to limit state taxing authority, U.S. states, for the most part, are free to go their own way in matters of tax policy, even if their tax policies deviate from those adopted by the federal government.[11] U.S. courts have preferred to ask Congress to decide questions on the legality of state powers of taxation, viewing the federal legislature as the proper forum for the balance of state and federal interests necessary in this area.

In addition to commerce clause considerations, the courts have considered due process clause restrictions on state taxation. The Due Process Clause of the Fourteenth Amendment of the U.S. Constitution provides that no state shall "deprive any person of life, liberty, or property, without due process of law". Due process issues at their heart are concerned with "the fundamental fairness of governmental activity"[12]: in state taxation this generally applies to questions related to a state's legal jurisdiction to tax or fair apportionment among tax jurisdictions. The due process clause "requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax".[13] It restricts a state's tax on income from interstate commerce to the portion of a corporation's total interstate income earned in and reasonably attributable to the taxing state.[14]

The U.S. Supreme Court had established a four-part test to ensure that state tax schemes comply with the due process and commerce clauses by having a connection with the object of taxation while simultaneously not burdening interstate commerce: the tax must be fairly apportioned, non-discriminatory against interstate commerce, fairly related to the services provided by the state, and applied to an activity which has a 'substantial nexus' with the taxing state (*Complete Auto Transit, Inc.* v. *Brady).*[15] In the 1979 case *Japan Line Ltd.* v. *County of Los Angeles*,[16] the U.S. Supreme Court further stated there was a greater need for uniformity in interstate commerce when foreign commerce was involved, and created two additional tests for the constitutionality of state tax schemes: the tax must not create a substantial risk of international multiple taxation, and must not prevent the federal government from 'speaking with one voice' when regulating commercial relations with foreign governments.

The 1968 case of *Zschernig* v. *Miller* is another legal obstacle to the involvement of U.S. subfederal governments in foreign affairs. In this case, the U.S. Supreme Court struck down an Oregon statute, directed at the U.S.S.R., which did not allow resident foreign citizens to inherit property if their home country barred U.S. residents from inheriting property.[17] This was seen as overruling the 1947 case *Clark* v. *Allen*, where the Supreme Court had let stand an identical California law because it held the law only indirectly affected U.S. foreign relations.

In addition, the 1799 Logan Act bans efforts by individual Americans to change foreign officials' positions on controversies involving the United States. However, this Act has never been enforced, indicating a general tolerance on the part of the federal government for the participation of individual citizens in U.S. foreign affairs.[18]

The U.S. Congress has the authority to regulate U.S. state taxation of both interstate and foreign commerce. The Commerce Clause of the U.S. Constitution states that "The Congress shall have the power...to regulate commerce with foreign nations, and among the several States and the Indian Tribes". Therefore, Congress has the authority to pass laws outlawing any state policy which interferes with interstate or foreign commerce, as well as passing laws on interstate or foreign commerce which legally override conflicting state laws.

However, despite this authority, Congress has remained largely on the sidelines in the regulation of state taxes, driven by the desire of both the state and federal governments to maintain state sovereignty over taxation. Despite the fact that the courts have asked Congress to consider the legality of certain state taxation powers several times, Congress has only once restricted the power of the states to tax income from interstate business: Public Law 86-272 in 1959 restricted state powers to impose corporate income taxes on exclusively interstate businesses. However, this law does not apply to foreign commerce: Congress has never acted to restrict U.S. state taxation of income from foreign commerce.

There is a debate whether this hesitancy by Congress is due to approval or inertia: the courts' claim of jurisdiction in this area under the dormant commerce clause may at least marginally deter congressional action. Moreover, state and local taxes often yield concentrated benefits to one state and only diffuse harm to others, providing little impetus for a nationwide consensus. At the same time, state political processes may provide a primary forum for resolving state tax policy, relegating Congress to a "somewhat duplicative" forum for dispute resolution.[19] Attempts at the federal level to set up broad general rules on state and local government taxes are likely to meet with sustained opposition from Congress, which fundamentally represents state interests. Although

powerful U.S. states can maintain regulatory standards at odds with federal and international norms, states can also perceive that their interests lie in changing their regulations to comply with external norms if doing so attracts more trade and investment to their jurisdiction, particularly if they are more economically dependent on out-of-state trade and investment.

The White House can make treaties which outlaw U.S. state regulations. Under the Supremacy Clause of the U.S. Constitution (Article 4), any state law in conflict with a U.S. treaty is considered void. In 1890, *Geofroy* v. *Riggs*[20] ruled that all areas of a state's power can be superseded by diplomatic commitments except for "surrender of republican forms of government and the cession of physical territories of particular states".[21] In a 1936 decision, *United States* v. *Curtiss Wright Export Corporation,*[22] the Supreme Court ruled that the power of the national government was an inherent attribute of sovereignty "in origin and essential character different from that over internal affairs", since the federal government's powers were based in the U.S. Constitution, whereas sovereignty had been immediately conferred upon the country's leadership when the United States declared its independence from Britain.[23] However, since U.S. treaties cannot be enacted without Senate approval, Congress still holds the ultimate power to override state laws by treaty. Whether it will use this power is another question. The states may perceive that their interests are aligned with those of foreign companies.

The Supreme Court has also refused to overrule state laws which conflict with administrative policies promulgated by the president. The president does hold persuasive power over the states in attempting to convince state legislatures to change their laws, since he can marshal support among congresspeople and governors for an administrative policy, especially if they belong to the same political party. This may lead to pressure from a governor or a state political party organisation on a state legislature to support a presidential policy in return for presidential backing in gubernatorial or congressional reelection campaigns. Presidential administrations with a strong pro-business stance may oppose the spread of U.S. state tax regulations, while presidential administrations supportive of states' rights may be more inclined not to limit state tax powers.

The Internal Revenue Service (IRS) is responsible for determining, assessing, and collecting internal revenue in the United States, including corporate income taxes.[24] In the United States, transfer pricing has been regulated since 1921 by Section 482 of the Internal Revenue Code, which gives broad powers to the Internal Revenue Service to increase corporate tax payments by shifting income between businesses under common control, regardless of whether the firms in question are deliberately trying to avoid taxes or not. The federal government has long promoted the arm's length standard (ALS) in its Internal Revenue Code. However, a September 30, 1981 report by the General Accounting Office accused the IRS of being lax in its interpretation of the arm's length standard. Further, 1986 revisions of Section 482 included formulary apportionment-type profit splitting and comparable profit interval methods as options for the IRS to use in evaluating transfer pricing. These revisions were criticised by U.S. states who felt they proved the IRS was tacitly admitting formulary apportionment methods were more accurate while still attempting to stop the states from using these methods. After its 1986 revisions, the IRS insisted on discrepancy for its profit splitting and comparable profit interval methods before the U.S. government agreed to the Organisation for Economic Cooperation and Development's 1993 transfer pricing guidelines promoting the use of the arm's length standard.[25]

The Department of the U.S. Treasury's mandate includes advising the president on domestic and international financial, monetary, economic, trade and tax policy; the Secretary of the Treasury is responsible for formulating and recommending domestic and international financial, economic, and tax policy.[26] The Office of Tax Policy assists the Secretary of the Treasury by developing and implementing tax policies and programs; establishing policy criteria reflected in regulations and rulings; guiding preparation of these policies for the IRS to implement through the Internal Revenue Code; negotiating tax treaties for the United States; representing the U.S. in multilateral organisations dealing with tax policy matters; and providing economic and legal policy analysis for domestic and international policy decisions.[27] The Treasury Department advises presidential administrations on state tax law, but does not interact directly with the states.

The U.S. Treasury Department has historically been one of the main proponents of the arm's length method at the international level. The department has promulgated the use of the arm's length method in U.S. bilateral international tax treaties and in multilateral organisations, such as the OECD, which attempt to set international tax policy.[28] The Treasury Department is "totally unsympathetic" with U.S. state desires to maintain formulary apportionment systems and remains opposed to having an inconsistent method for evaluating transfer pricing practices in use at the U.S. subfederal level. The Treasury Department was widely viewed as pushing various presidential administrations to propose federal laws outlawing worldwide combination unitary (WWC) formulary apportionment methods at the state level, in order to prevent a divergent system for evaluating transfer pricing from taking hold at the U.S. subfederal level.[29]

The Department of State is the lead institution for the conduct of American diplomacy, and the Secretary of State is the president's principal foreign policy adviser.[30] All bilateral tax treaties which the U.S. has signed name the arm's length standard as the method to be used for evaluating transfer pricing policies within multinational enterprises. In order to maintain the integrity of these treaties, the State Department sought to accommodate foreign governments which protested U.S. state use of the WWC method. Moreover, the Department feared use of the WWC method at the state level created a risk of double taxation which could distort international investment decisions and reduce the flow of foreign investment to the U.S.[31]

b) Agendas

The different sections of the federal administration responsible for setting tax policy promote the use of the arm's length standard (ALS), both within the U.S. and other countries, for evaluating transfer pricing practices. The U.S. federal government believes that enshrining the use of the ALS through its web of bilateral tax treaties will ensure a more secure international trading and investment environment for U.S. MNEs. This goal is most strongly pressed by the U.S. Department of the Treasury and the U.S. Department of State, which both wish to avoid the possibility of retaliation by foreign governments if the U.S. is seen as breaking international treaty commitments by allowing the states to use

an alternate system for evaluating transfer pricing. These departments also fear their credibility will be threatened if they are seen as backing down from a policy position they previously lobbied other countries to adopt, and that any lessening in credibility could undermine U.S. negotiations on a range of other international issues.

However, the U.S. Congress, and to a lesser degree, the various presidential administrations, need to maintain a base of state political support. Congressional members feel this need most strongly since they are directly dependent on their home state political apparatuses for support in their re-election campaigns. In addition, members of Congress depend on state voters for reelection: any policy they support which deprives their state of tax revenue might incur censure from voters. The president is also dependent on state electoral votes and on state political apparatuses for his reelection prospects. However, since the voting relationship here is less direct, the political importance of a state to a presidential reelection campaign and the popularity of an administration provide variations in presidential dependence on state approval.

c) Assets

i) Political

The federal government holds substantial assets allowing it to regulate state policies which interfere with international commerce. Under the Commerce Clause of the U.S. Constitution (Article 1), Congress can pass laws outlawing any state policy which interferes with interstate or foreign commerce, and the White House can make treaties or executive agreements which outlaw any state regulation. In addition, the Supremacy Clause of the Constitution (Article 4) allows the judiciary to override any U.S. state law which is in opposition to a specific federal law passed by Congress or, under the informally developed 'dormant commerce clause', to repeal any state law which interferes with national commerce if Congress has not passed a federal law on the matter.

The federal government can also promulgate policies or pass laws to solve state problems at the federal level, eliminating the need, at least theoretically, for state regulations. For example, states do not have the same degree of access as the federal government to the financial records of MNEs, since the IRS has the power to demand

information from foreign tax authorities through its network of bilateral treaties. This was a particularly potent federal asset in the debate over state use of the WWC method: one of the chief justifications states gave for using the method was that lack of access to company records made it impossible for states to accurately use the ALS. If the IRS could offer to share details of MNE transfer pricing arrangements with the states, or help them audit MNEs, they could remove one of the states' chief arguments for using the WWC method. At the same time, the IRS could promise to strengthen its own policies and enforcement capabilities to stop transfer pricing violations from occurring within its jurisdiction.

ii) Economic

The federal government can influence state policies by promising or withholding economic help to states in the form of grants or subsidies. The United States has been cited as an example of "classical federalism" in fiscal matters, embodying the concept of financial autonomy for subfederal units: each state is responsible for raising its own resources and for spending them.[32] Despite the existence of this model, the U.S. federal government has traditionally given money to the states, although the amounts have varied widely. Starting on a small scale early in this century, and expanding during the New Deal and Great Society eras of the 1930s and 1960s, intergovernmental federal cooperation in the U.S. came into being through the grants-in-aid system of transferring funds for some specified purpose from the federal government to the subfederal governments.

However, during the period when the unitary tax controversy reached its peak (1980-1993), the federal government was undergoing both a period of fiscal deficits and a policy shift towards placing more of a revenue burden on the states through 'fiscal federalism'. In January 1982, President Reagan's Federalism Initiative promoted the role of state policies as experimental laboratories in spending federal 'block grants' which did not specify how aid was to be spent. Reagan placed a much greater responsibility on the states to function without stringent federal supervision. In this environment, "the stage was set for high levels of fiscal tension and conflict in the intergovernmental system".[33]

3) State governments

a) State corporate income tax

Elazar claims that Reagan's fiscal federalism policies helped states realise they were polities in their own right, not just arms of the federal government: in the face of scarcity and decreasing federal aid, all of the states eventually began to formulate policies and increase taxes to meet their expenditure needs.[34] From 1975 to 1992, state and local tax collections nearly quadrupled. One of the 'growth' taxes at the state level has been the corporate income tax, which 46 states currently impose. Many states require that corporations pay an annual franchise or privilege tax, which is levied on the right or privilege of doing business in a state; these are measured by either the corporation's net income or its capital stock. In addition, numerous states have direct corporate net income taxes. However, these corporate taxes still do not provide states with nearly as much revenue as general sales and individual income taxes.[35] In 1995, state corporate income taxes generated only 7.3 percent of state tax collections.[36]

Although the U.S. Constitution declares that each state has the right to any tax source, except those outside of its territory, in practice, each level of government in the U.S. has tended to focus on particular revenue sources, with local governments relying on property taxes, states on sales taxes, and the federal government on income taxes.[37]

The states' net corporate income tax base broadly conforms to the federal corporate income tax base, prior to the division of this base among the states, and many states have incorporated "key operative terms" from the federal statute into their tax statues in order to meet taxpayer demands for ease of compliance and auditing.[38] Some states have been unwilling to broadly incorporate the U.S. Internal Revenue Code into state statute, for fear of providing Congress with a de facto empowerment to change state tax laws. However, every state except Alabama, Arkansas and Mississippi uses federal taxable income as the starting point for the determination of state corporate income tax liability.[39]

b) Legality of state activity in the international arena

The U.S. Constitution forbids subfederal governments from assembling their own armies or navies, declaring war, entering into treaties, violating national treaty commitments, or levying duties on imports or exports.[40] However, most state international activism does not fall into any of these forbidden categories, and most of the few court pronouncements in this area have been ambiguous enough to encourage subfederal governments to put forth policies to see if they are in fact illegal.[41] They have been further encouraged by the Tenth Amendment of the U.S. Constitution, which declares that "the powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people". Under this amendment, states have held that they are not bound by federal laws or international treaties unless it becomes apparent that state laws interfere with international commerce or U.S. foreign policy.[42] They therefore view the national government's power to regulate foreign affairs as limited to overruling explicitly contradictory state laws.

Similarly, despite the constitutional prohibition on state and local governments entering into treaties with jurisdictions abroad, 'compacts' with foreign jurisdictions are allowed if they receive congressional approval. However, a large number of bilateral agreements between subfederal U.S. governments and foreign authorities have been signed without congressional consent, and the U.S. Supreme Court has only once invalidated such an international agreement, in an 1840 extradition case.[43]

The executive and legislative branches often denounce subfederal activism but do little to stop it in practice.[44] The Immigration and Naturalization Service (INS) asked U.S. cities not to create sanctuaries for illegal immigrants, and the Department of Commerce expressed concern that state export-financing programs might violate the GATT. Yet in neither of these cases did the federal government take legal action against subfederal activities that it denounced.[45]

c) State tax autonomy

The Commerce Clause of the U.S. Constitution is primarily concerned with preventing a state from favouring its own goods over those from other states or countries,

and with preventing local regulations from interfering with the free flow of national commerce. Indeed, the desire to avoid trade wars between states using their tax powers to promote their own economies at the expense of neighbouring states compelled the framers of the U.S. Constitution to subject interstate commerce to the power of the federal government.[46]

The federal courts have consistently overruled state and local taxes which benefit local companies at the expense of out-of-state businesses.[47] These decisions have been applied not only to state taxes limited to out-of-state businesses or which explicitly tax out-of-state products at higher rates than those of local sellers, but also to taxes that have the effect of discriminating against interstate commerce, even if the effect is unintentional.[48]

However, the courts have also implicitly balanced any harm to locational neutrality from discriminatory state laws against the benefits ascribed to state and local government tax autonomy: economic efficiency from state level decisions on how to finance state public goods; the promotion of desirable tax competition between separate jurisdictions; increased government responsiveness to voter preferences; and the promotion of government experimentation with tax regulations, which may lead to new policy solutions.[49]

At the same time, states do have incentives to coordinate their tax laws, since a more uniform trading environment will generally be more attractive to business. 23 of the 46 states with corporate income taxes have adopted the Uniform Division of Income for Tax Purposes Act (UDITPA), which was approved by the National Conference of Commissioners on Uniform State Laws in July 1957.[50] UDITPA provides rules which attribute the income of a corporate taxpayer to the various states in which it is taxable. In a few of the states which have adopted the act, taxpayers may chose to use an alternative apportionment or allocation method. However, several states have enacted modifications to UDITPA, especially with regard to the definition and weighting of the three-factor formula of property, payroll, and sales, since UDITPA apportions business income of interstate operations among states using property, payroll, and sales (excluding

intracorporate sales) as equal weights; nonbusiness income (such as royalties and capital gains) is allocated to the state of corporate domicile.[51]

Although existing tax compacts between states are impressive, the sheer number of state legal and tax provisions makes it difficult for subfederal jurisdictions to coordinate their regulations completely. At the same time, businesses may not desire complete uniformity between state tax laws, since regulatory differences sometimes allow them to lower their corporate tax burden or otherwise arbitrage state regulations to their advantage.

d) Actors

Debates over subfederal powers to enforce tax regulations are viewed by the states primarily as an issue of states' rights. Because of this, individual U.S. states lobbying at the federal level for the right to enforce a specific state tax or economic regulation are often helped by state group associations. As the federal grants progress increased in importance and complexity from the 1940s to the 1960s, U.S. state and local officials increasingly set up operations in Washington, DC to influence the federal government and gain information about the grants process. Increasingly, these organisations became the lead representatives of state interests in national policymaking.[52] However, although U.S. states represent their interests at the federal level through such organisations, if states see their own interests as aligned with changing their regulations to attract business, even foreign business, they may not exercise their assets through these channels.

The Multistate Tax Compact is an interstate compact enacted by its member states in 1967 under the aegis of the Council of State Governments. An interstate compact promulgates a uniform law among U.S. states, as well as constituting an agreement among states to jointly exercise their authority in a particular area.[53] MTC regulations are advisory in nature, and are only binding on states if they adopt them internally.[54] Starting from an original seven, the MTC now has twenty member states and sixteen associate members; California entered the Multistate Tax Compact in 1974.[55] The core purpose of

the Multistate Tax Compact is to promote uniformity and compatibility in significant areas of state tax systems.

The Multistate Tax Commission (MTC) was created by the Multistate Tax Compact members in 1967 as a means to recommend uniform measures to the states.[56] MTC works to administer state tax laws which apply to multistate and multinational enterprises, and serves as the governing and administering agency of the Multistate Tax Compact. In addition, the MTC attempts to protect state fiscal authority before Congress and the courts, and encourages business compliance with state tax laws through education, negotiation and enforcement. Forty-five states (including the District of Columbia) participate in the MTC.[57]

A major focus of the MTC's work on state tax uniformity work has been the development of business income tax allocation and apportionment regulations, since it views the UDIPTA, embodied in Article IV of the Compact, as providing only a broad framework. The MTC's allocation and apportionment regulations are intended to remove ambiguity and ensure tax laws and regulations in this area are substantially uniform across states, lessening the compliance burden on taxpayers, avoiding duplicative taxation, and ensuring that all of a business' property, payroll, and sales are assigned to the numerator of only one state's apportionment factors.

The Multistate Tax Commission also conducts joint audits for the states, on request, on income and sales and use taxes in order to try to avoid conflicting audits from several different states. The MTC generally works with smaller states which have fewer resources; large states such as California rarely use these services.[58] States which use the MTC's auditing services can chose whether or not to accept their evaluations.[59]

Substantial animosity exists between the MTC and business groups.[60] A number of major corporations have been resistant to audit inquiries from MTC staff, despite a U.S. Supreme Court ruling in February of 1978 sustaining the validity of the Compact.[61] In *United States Steel Corp.* v. *Multistate Tax Commission*,[62] the Supreme Court rejected the plaintiff's contention that, among other things, the Compact violates the Compact

Clause of the U.S. Constitution (Article I, Section 10), which provides that "(n)o State shall, without the Consent of Congress...enter into any Agreement or Compact with another state, or with a foreign power".[63] The court ruled that congressional consent is required for a compact between states only if the compact would increase the political power of the states to the extent that it "may encroach upon or interfere with the just supremacy of the United States".[64]

The MTC supports the principle of worldwide combination, and a resolution endorsing state use of this method was unanimously adopted by Compact members in May 1977. The MTC became viewed in the 1970s and 1980s as "the most active and effective group" at the federal level in support of the states' right to use the WWC unitary method.[65]

The National Governors' Association (NGA) is a bipartisan organisation which provides a forum for U.S. state governors to influence national policies, provide information on state innovations and practices, and help solve state-focused problems, including state tax and international trade issues. The NGA established an Office of State Federal Relations in Washington, DC in 1967, which provides lobbying and policy support for priorities set annually by state governors. The NGA tries to protect state tax bases, and feels states should be able to determine their own taxation systems, including use of the WWC method.[66]

The Western Governors' Association (WGA) is an independent, non-partisan organisation of governors from 18 western states, including California. Established in 1984, the association was formed to address important policy and governance issues in the West, advance the role of Western states in the federal system, and strengthen the social and economic fabric of the region. The WGA seeks to develop and carry out programs in the areas of "economic development, international relations, and state governance".[67] This organisation protested against possible federal interference with state unitary tax policies and expressed concerns about state sovereignty in the face of international tax policies embodying the arm's length standard. WGA member states also lobbied the federal government for protection for state sovereignty during the

establishment of the World Trade Organisation (WTO), and for the expansion of that protection in negotiations for the proposed Multilateral Investment Agreement (MIA).[68]

The Federation of Tax Administrators (FTA) was organised in 1937 as a non-profit association representing all the principal U.S. state government tax agencies. The FTA seeks to avoid the preemption of state tax sovereignty and authority in international trade agreements, and supported the right of the states to determine their own taxation policies, including use of the WWC method. [69]

National Conference of State Legislatures (NCSL) is a bipartisan organisation whose goals include ensuring state legislatures have a strong, cohesive voice in the federal system.[70] NCSL has lobbied to include protection for state authority in U.S. legislation implementing international agreements which liberalise world trade and investment, and supports the states' right to use the worldwide combined unitary method.[71]

The Council of State Governments (CSG) is a nonpartisan, nonprofit organisation whose goal is to promote the sovereignty of the states within the U.S. federalist system of government. CSG's principal constituents are state legislators, state cabinet and agency officials, and state constitutional officers and their staff.[72] CSG has a committee responsible for developing activities in the international arena of importance to U.S. states, including the coordination of exchanges and discussions between U.S. state and foreign government officials, and the development of special conferences on international issues. CSG also helps in the preparation of amicus briefs to the U.S. Supreme Court in cases involving states' rights. CSG views are coordinated with the National Conference of State Legislators, the National Association of Attorneys General, and the National Governors' Association. The CSG was supportive of the states' right to use the WWC method.[73]

Citizens for Tax Justice is a research and advocacy organisation which focuses on federal, state and local tax policies. CTJ was founded in 1979 "to give ordinary people a greater voice in the development of tax laws…against the armies of special interest

lobbyists for corporations and the wealthy".[74] It is in favour of fair taxes for middle and low-income families, "requiring the wealthy to pay their fair share", closing corporate tax loopholes, adequately funding important government services, reducing the federal deficit, and taxation which minimises the distortion of economic markets.[75] Citizens for Tax Justice was the only lobbyist at the federal level to join with state organisations in support of the states' right to use the unitary tax method.

On an individual basis, in addition to **California**, states which were active in defending their use of the unitary method included **Colorado, Florida, New York, North Dakota, Oregon, Washington, Montana**, and **Alaska.**[76]

e) Agendas

The policy agendas held by U.S. states during the debate over California's unitary tax were divided between desires to promote their jurisdictions' competitiveness, and strongly-held beliefs that states had the right to formulate their own economic policies. Even if states do not employ a particular economic regulation themselves, they typically support other states which implement controversial regulations on the grounds that each state has the right to formulate its own economic policies under the U.S. federalist system. This is particularly true in regards to revenue-raising policies, such as taxes, which are considered a key component of state sovereignty. States may also wish to support another state's right to implement an unpopular regulation they are not themselves employing in order to attract business to their own jurisdiction. This is especially true if a regulation has international implications, since there is a strong element of competition between U.S. states in international trade promotion.[77]

All U.S. states strive to attract investment to and trade with their state in order to promote their economies. Local regulations which violate international norms are often put in place to promote specific state economic interests, or help local populations cope with the impact of external economic forces by providing special help. If such regulations lead to sanctions from the U.S. federal government, foreign governments, or international organisations, or to diminished trade and investment from businesses upset with a state policy, states may have to reevaluate the efficiency of such regulations. However, state

officials may seek to maintain regulations which violate international norms if they provide a large source of income, or a revenue source difficult to replace, in order to provide services to their constituents and gain reelection.

Furthermore, the states maintained that their use of the WWC method did not cause large problems or interfere with economic development or international commerce.[78] As foreign direct investment in the U.S. grew throughout the 1980s and the number of U.S. MNEs expanded, a larger proportion of state revenue became dependent on taxing overseas assets and the states' position hardened.[79] Many state advocates felt they must follow the principle of "equal treatment of similarly-situated taxpayers" when accounting for the income within a state's jurisdiction, and they viewed worldwide combined formulary apportionment as a means to place all businesses on an equal footing, whether they operated exclusively in-state, exclusively within the U.S., or worldwide.[80]

The WWC method was seen as a means to cope with increased international activity in the state, and revenue raised from a special fee imposed on MNEs electing not to be taxed under the WWC method after California's 1986 unitary reforms was specifically earmarked to help cope with the impact of increased international activity in the state. In addition, the early 1980s saw a dramatic rise in the level of foreign direct investment in the U.S.,[81] and there was a belief that foreign MNEs operating in the U.S., especially Japanese companies, were not shouldering their fair share of the U.S. tax burden.[82] The unitary tax issue was therefore framed by the states as a way to prevent tax avoidance by large multinational enterprises, especially foreign MNEs.[83] California, along with other states, ultimately reversed this belief with the growing realisation that the state was economically dependent on out-of-state, and particularly, foreign business, and that maintaining the unitary tax method was ultimately harming state interests by driving away investment. However, the state of California always sought to maintain the principle that it could use the WWC tax method in order to avoid paying back taxes the state had already collected under the method.

f) Assets

i) Legal

Article 10 of the U.S. Constitution declares that "the power not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people". The courts have been stout defenders of most states' rights arguments in the area of taxation, viewing the ability to provide revenue as central to state sovereignty. State regulatory powers are both strong under the highly developed U.S. legal system, and wide in that state laws cover a broad range of areas.

However, in the 1985 case *Garcia* v. *San Antonio Metropolitan Transit Authority*, the U.S. Supreme Court stated that the "principal means" by which the role of the states in the federal system is to be ensured "lies in the structure of the Federal Government itself".[84] The court thus ruled that the main protector of the states' status as vital decision-making entities in the U.S. system would have to be the clout of states within the political institutions of the national government, rather than constitutional safeguards enforceable by the Supreme Court. States, in short, would have to look out for themselves by lobbying in Washington against possible national intrusions into their policy domain.[85] On April 20, 1988, *South Carolina* v. *Baker* reaffirmed the Garcia decision that the Constitution contains no substantive protections for state and local governments against national regulatory powers. Instead, national intervention may be limited by the courts only if the U.S. political structure that authorised it is proven defective in representing state governments.[86]

Under the U.S. constitutional framework, states have political power in the federal government through two means: representation in Congress, which has the power to pass federal laws, and possession of the electoral votes needed to technically elect a U.S. president. These two channels give states additional informal means of influencing national policymaking, since state-level political networks are vital in providing ground-level support to elect congresspeople and the president and, subsequently, in supporting the passage of congressional legislative packages. These channels of influence support much of the substantial legal maneuvering room for states within the American federalist system. In addition, since state governors have essentially the same electoral base as U.S.

Senators, the governors are seen as a particularly effective channel for state input on national policies.

ii) Economic

In their negotiations with business, U.S. states have the power of controlling large economies on an international scale which cannot easily be ignored by MNEs.[87] Certain states may possess attractive economic resources specific to their jurisdiction, such as dominance in a specific industry (computers, aerospace, entertainment), natural resources (agricultural, timber, oil), or human resources (highly educated, skilled, or technical workers). U.S. states also possess strong marketplaces with relatively high spending power; more populous and wealthier states have an obvious advantage in state-firm bargaining over issues that involved market access. As well, states which, through immigration, possess cultural or economic links to foreign countries may be particularly attractive to those countries as partners in trade and investment.

iii) Institutional

U.S. states hold substantial institutional power through the size and strength of state government bureaucracies. The U.S. federal government's "War on Poverty" under President Johnson's Economic Opportunity Act of 1964 laid the basis for the bureaucratic growth of U.S. state governments, and thus their ability to act independently of the federal government. Under President Nixon, the administration of these programs was decentralised in an effort to increase local initiative. The high level of bureaucratisation that remained in place at the subfederal level, no longer tightly controlled by the U.S. federal government, led to an increase in state activism in all areas of government.

This increased bureaucracy also supported the increasingly institutionalised involvement of subfederal governments in international affairs. The past twenty years have seen a surge in state executive agencies and legislative committees which monitor and promote state involvement in international economic affairs. These groups work in conjunction with national and regional multi-state associations, relevant federal institutions, and foreign governments. Such state institutional arrangements for conducting international relations have developed from initiatives put forth by individual

governors, pressures from local business constituents, and encouragement from the executive branch of the federal government.[88]

4) Firms

a) Actors

State taxes often differ in their impact on small and large companies, especially if they are intended to discriminate in favour of in-state business. Most large U.S. businesses do not confine their activity to one state, making regulations which promote a specific state less beneficial for them. In addition, state revenues lost from revoking a targeted tax are often recouped through increases in the overall level of state sales or corporate taxes. Since multinational enterprises are outnumbered by small and medium-sized businesses in most states, most companies operating in a state would favour a specific tax, which may not impact them at all, over an overall increase in the level of business taxes. However, groups which support the removal of an unpopular targeted state tax can argue that its repeal will attract more corporations to the state, raising the level of economic activity and boosting state sales and income tax revenue so much that an increase in overall tax levels will not be needed.

State economic regulations can also divide the lobbying tactics of U.S. and foreign-domiciled MNEs if the impact of the regulation differs based on a company's nationality. In particular, since U.S. courts in the 1979 *Japan Line, Ltd.* v. *Los Angeles*[89] case held that the "enhanced risk of multiple taxation" and foreign retaliation means U.S. states must be especially sensitive in areas of taxation which involve foreign commerce, foreign-domiciled companies have a stronger legal case against U.S. subfederal tax regulations.[90]

The Committee on State Taxation (COST) consists of more than 400 U.S. companies with income from multistate and international sources; a minority of its members have foreign headquarters. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce in direct response to the California Franchise Tax Board's decision to apply the WWC method to the foreign activities of

U.S.-based MNEs on a mandatory basis. COST lobbies against any arbitrary definition of a unitary company and seeks to defend MNEs on charges that they are deliberately shifting taxable income out of a state. COST was incorporated as a separate organisation on January 1, 1992.

COST has been actively involved in the analysis of all aspects of state taxes and their impact on domestic and international business transactions, especially state taxation of foreign source income. It is against what it sees as extraterritorial taxation under state WWC methods, viewing the WWC method as radically departing from accepted principles of federal and international taxation, and interfering with the foreign relations and commerce of the United States.[91] COST further objects to the method's use because no deferral of payment is allowed, and dividends from foreign subsidiaries are taxed with no allowance for taxes already paid oversees. COST contends that both of these actions violate the tax principles embodied in the U.S. network of bilateral tax treaties, and supports the need for federal guidelines on state taxation of foreign source income.[92] However, COST is in favour of letting companies elect whether they wish to be evaluated under the worldwide unitary method or the arm's length standard.

The debate over state use of the WWC method was sensitive for COST because the Multistate Tax Commission lobbied heavily in favour of the states' right to use the method, and the relationship between COST and MTC in the early 1980s was "not good".[93] At this time, there was an impression among COST members that anything the MTC supported as tax policy must be bad for business, and therefore, business should oppose it.[94] COST and the MTC had almost no interaction during the 1980s, due to the feelings of COST members.[95]

The U.S. Council for International Business (USCIB) is the official U.S. affiliate of the International Chamber of Commerce, the Business and Industry Advisory Committee of the OECD, and the International Organisation of Employers. USCIB was founded in 1945 to promote an open system of free trade and bring the collective views of business to bear on regulatory issues and business practices around the world.[96] USCIB

has over 300 member U.S. corporations, including some foreign-headquartered U.S. affiliates, and lobbies U.S. and international policy makers.

USCIB has policy committees on Taxation, Trade Policy, Multinational Enterprises, and Investment. The Taxation Committee has over 250 corporate tax counsels as members, and seeks to enhance the competitiveness of U.S. business by promoting sound international tax policy, including the simplification of foreign taxes for U.S. multinationals and the deferral of U.S. taxes on income from foreign business activities. USCIB produces extensive recommendations on all proposed U.S. regulations on transfer pricing and revisions to the U.S. Model Tax Treaty. Through the BIAC, it also provides input on the OECD Transfer Pricing Guidelines and Model Double Taxation Convention.[97]

USCIB's Taxation Committee has said it will continue to "oppose adoption of formulary apportionment in the U.S. on a federal basis, and other legislation which would override U.S. tax treaty obligations or otherwise discriminate against foreign taxpayers, in part on the grounds that such action would expose U.S. companies abroad to retaliation".[98] However, the USCIB was originally split on whether to lobby for optional use of the WWC unitary method or a total ban, because several of its foreign-domiciled members benefited from filing under the method. The matter rose to the USCIB's Executive Council, which gave permission for the group to come out in favour of outlawing the method completely, despite fears that some members would leave the organisation.[99]

The International Chamber of Commerce (ICC) is a world business organisation which promotes international trade, investment, and the market economy system. Located in Paris, the ICC communicates with the World Bank, the International Monetary Fund, the European Union, the World Trade Organisation, and other U.N. organisations to establish the business stance on broad issues of trade and investment policy as well as on subjects such as international taxation. The ICC supports the undiluted use of the international arm's length standard as the only legitimate approach to transfer pricing regulations.[100]

In 1986, the International Chamber of Commerce condemned unitary taxation, stating that: "The ICC views with concern the inevitability than an increase in cases in which profits taxes are levied by political sub-divisions unencumbered by treaty obligations will result in mounting double taxation of profits (which tax treaties set out to avoid). The dangers of double taxation and the administrative problems arising from the taxation policy of California, and other political sub-divisions, have undoubtedly deterred would-be investors from making investments which would otherwise have been undertaken".[101]

The National Association of Manufacturers (NAM) is a nonprofit business association comprising more than 14,000 manufacturing and related businesses operating in the U.S., of which approximately 10,000 are small manufacturers. The vast majority of their membership consists of U.S.-domiciled companies.[102] NAM's mission is to enhance the competitiveness of manufacturers by shaping a legislative and regulatory environment conducive to U.S. economic growth; in this vein, it strives to reduce foreign trade barriers as a means of increasing U.S. exports. NAM has a Vice President of Taxation and Economic Policy, whose goals include simplifying the international tax regime to reduce the overhead costs of export production and foreign investment.[103]

NAM feared state use of the worldwide unitary tax method might trigger foreign retaliation which would interfere with foreign trade, disrupt international flows of capital and technology, and harm U.S. commercial interests abroad.[104] However, the organisation was not strongly involved in lobbying against the unitary method, since most members did not view the issue as a priority.[105]

The Business Roundtable is an association of approximately 200 CEOs from U.S. headquartered companies seeking to ensure that U.S. public policy helps the competitiveness of U.S. business. The Business Roundtable maintains a task force on fiscal policy and a task force on international trade and investment, which has aims to enhance the competitiveness to U.S. business in global markets.[106] Although there was mixed sentiment among the organisation's membership over whether to take a strong stance on the unitary issue, since some members benefited from filing with the states

under the WWC method, The Business Roundtable opposed state use of the WWC method as contrary to established international norms.[107]

The U.S. Chamber of Commerce, represents an underlying membership of more than three million businesses, of which over 96% have fewer than 100 employees. The Chamber is an advocate for the American business community, particularly small business, and champions the principles of private enterprise before Congress, the White House, regulatory agencies, and the courts. The Chamber was opposed to state use of the WWC method and started a 'red-flag' campaign to encourage companies not to invest in states which used the method.[108]

The Tax Foundation was founded in 1937 as a non-profit, non-partisan educational organisation to promote "tax consciousness" in the public by distributing "objective, unbiased" information on public sector finance at all levels of government and the general public.[109] The Tax Foundation promotes the following principles: simplicity of tax compliance, stability through non-frequent changes in the tax code, a well-informed citizenry which understands the tax system, neutrality, no retroactivity in tax legislation, and the promotion of the free flow of goods, services, and capital, domestically and internationally.[110] Although the Tax Foundation did not take a position on the states' use of the WWC method, it issued documentation describing the controversy and decrying uncertainty over the method's legality as a complicating factor for both business and the states.

The Tax Executives Institute (TEI) is a professional association of 4,000 business executives responsible for tax affairs. TEI is concerned with the administrative aspects of tax policy, with the goal of reducing the costs and burdens of taxpayer compliance. TEI has a State and Local Tax Committee, and has long been interested in minimising and rationalising the administrative and fiscal burdens placed upon multijurisdictional businesses through the use of the worldwide combined unitary tax method.[111]

However, TEI held no uniform opinion on whether worldwide combination was a fair method of taxing a business, since TEI contains a large number of both California and foreign-based companies.[112] The broad-based nature of the group's membership means it often fails to reach a consensus on controversial policy questions.[113] However, TEI stated it was in favour of allowing taxpayers a yearly election to use the worldwide unitary method if they so chose, along with more precise definition of which members of a corporate group could be included in a combined tax return; they also opposed the inclusion of foreign subsidiary dividends in any unitary income base subject to taxation.[114]

The American Tax Association, The National Association of Tax Practitioners (NATP), and **The National Tax Association (NTA)** are leading non-profit professional associations for people who work on tax issues in the U.S. Although they do not generally take positions on tax policy issues, these groups sponsor continuing education classes which are required for all U.S. Certified Public Accountants (CPAs), and hold meetings to decide on common tax practices. Participation in these bodies ensures that all the professionals involved in any taxation controversy in the U.S. know each other and meet on a regular basis. This means that, in effect, foreign and domestic-owned companies, small and large firms, and companies from every U.S. state are in constant contact with each other through professional tax bodies: an argument over subfederal taxation could travel among different cities through different meetings of these organisations.[115]

The European-American Chamber of Commerce (now known as the European-American Business Council) has a membership of European and American companies which lobby to promote non-discriminatory, unrestricted transatlantic trade and investment.[116] The Chamber was against state use of the WWC method both on the grounds that it contravened U.S. federal principles and that it might provoke retaliation from European governments, sparking a transatlantic trade dispute.[117] The Chamber lobbied against the WWC method in part by trying to convince both policymakers and the public that foreign-domiciled companies contributed greatly to the U.S. economy, and

that any discrepancy in the amount of tax these companies paid to the U.S. federal or state governments could be at least partly explained by other means.[118]

The National Foreign Trade Council (NFTC) promotes "an open international trade and investment regime", and supports multilateral agreements and rules-based trade, NAFTA, and the new WTO round.[119] Its members consist of 500 U.S. companies with substantial international interests.[120] The NFTC supports tax legislation which allows U.S. businesses to successfully compete against foreign companies. In keeping with this goal, the Council supported reform legislation on the unitary method which would ensure that states "equitably" taxed foreign source income, including dividends, earned by U.S. companies, so that U.S. businesses could successfully compete against their foreign counterparts.[121]

The Confederation of British Industry (CBI) represents the views of all sectors of British companies. The CBI opposed the mandatory application of worldwide unitary taxation in California as contrary to international tax policies and leading to an excessive burden of compliance on British firms.[122] The Confederation of British Industry formed the **Unitary Tax Campaign (UTC)**, a group of 65 British firms operating in the U.S., which led British efforts to fight U.S. state use of the WWC method. The UTC lobbied for: a) worldwide application of the international standard of arm's length/separate accounting; b) determination of the water's edge definition in state law according to the principles set out in the U.S./UK tax treaty; c) U.S. state corporate taxes not exceeding the burden of compliance required for U.S. federal tax purposes.[123]

The **Organisation for International Investment (OFII)** was founded by foreign investors in the U.S. to be their representative on tax issues, in particular on the debate over U.S. state use of the WWC method. OFII worked on this issue in coordination with the Union of Industries of the European Community, the Unitary Tax Campaign, and the Organisation for Economic Cooperation and Development's Business Industry Advisory Committee (BIAC).

OFII argued that foreign investors were discriminated against in the states' application of the WWC method, since: a) foreigners were taxed on financial income (book income) from sources outside the U.S., not taxable income. Under the Internal Revenue Code provisions, corporate taxable income averages only 40-50% of book income. Because of this alone, they argued, foreigners were double taxed compared to U.S. companies; b) all of the failings of the unitary formula concept, such as factor distortions and currency exchange rate distortions, have a significantly greater impact on foreign investors than U.S. companies because they generally have more of their business activities located outside of the U.S.[124]

The **Business and Industry Advisory Committee (BIAC)** of the Organisation for Economic Cooperation and Development represents private sector interests from the OECD's 29 member countries. Located in Paris and founded in 1962, the BIAC was also opposed to the use of the worldwide combined unitary method by any tax jurisdiction.[125]

Japanese groups which lobbied on the unitary tax issue included the **U.S. Japan Businessmen's Conference**, the **Japan-U.S. Economic Relations Group**, and the **Electronic Industries Association.** All of these groups sought the abolishment of the unitary tax through either state or federal laws, and argued their members would reduce investment in U.S. states using the method, increasing unemployment in the U.S. and worsening U.S.-Japanese trade relations. Sony CEO Akio Morita also founded a **Worldwide Unitary Tax Council** for the Keidanren (the Japan Federation of Economic Organisations), of which he was vice chairman. In December 1987, the Keidanren replaced this group, and its California branch, the **California Investment Environment Council**, with an **Investment Promotion Council,** made up of 171 Japanese firms, to promote non-contentious Japanese investment in the U.S. Japanese lobby groups were most concerned with the high costs the mandatory WWC method was imposing on their companies, since Japanese firms were making large new capital investments in California. These subsidiaries often had high start-up costs in the U.S., but, under the WWC method, the U.S. states effectively taxed their parent company's high profits in Japan. In addition, companies in Japan had a very different system of fringe benefits, so

they argued that payroll comparison between the two countries, in particular, were inaccurate.

In addition to group organisations, U.S. companies who were particularly active lobbyists against California's use of the WWC method included: General Mills, Ford Motor Co., Firestone Tire & Rubber, Honeywell, Allegheny Ludlum Industries, Kraft, TRW, Minnesota Mining and Manufacturing Co., PPG Industries, and Hewlett-Packard Company. IBM was also a strong lobbyist against the unitary tax,[126] along with The Coca-Cola Company.[127]

b) Agendas

All firms want to maximise profits by paying as few taxes as possible. Therefore, the bottom-line financial benefit or disadvantage of a state tax regulation will often determine a firm's stance on a subfederal policy issue. Moreover, since tax laws differ in their specific impact on various companies, there will always be companies that want these laws fine-tuned in their favour, through adjustment of definitions or ratios, in ways that have little to do with ideology.

However, there will also be U.S. companies concerned with the economic consequences of incurring retaliation from foreign governments offended by U.S. state regulations. Equally, companies may believe that in the long-term, adherence to one disadvantageous international norm will be overcome by the benefits of belonging to a set of standards which allow businesses to operate more easily on an international basis. U.S. firms with extensive overseas involvements strive to promote the principle of a 'level playing field' between themselves and their foreign competitors by having all MNEs adhere to the same set of international norms, equally applied. A business group organisation may opt for a compromise option if some of its members benefit from a certain regulation and others do not.

Many smaller firms which do business only in the U.S. may not care about U.S. state violations of international norms; instead, they may feel that such 'violations' are measures designed to help them against competition from global business or global

economic events. Small or in-state firms may also fear that any measure which results in fewer taxes for MNEs will result in a loss to state revenue, leading to a rise in general state tax levels which will more heavily affect small firms.

c) Assets

i) Political

U.S.-domiciled companies can argue their status as constituents, stressing that they should not be hampered by burdensome state tax regulations or suffer losses from foreign retaliation over state laws. MNEs domiciled in an offending state can make these arguments even more potently, especially if the threatened foreign retaliation is directed against a specific state. Foreign-domiciled MNEs, meanwhile, can enlist the support of their home governments to impose country-wide sanctions against a particular U.S. state, or against the U.S. as a whole, if subfederal regulations remain unchanged. Although there is no quantitative work in this arena, the trend points clearly towards a growth in this type of lobbying as U.S. state regulations have increasingly impacted foreign companies over the past twenty years. Examples of foreign companies enlisting their home governments to pressure U.S. states started with the California unitary case, detailed in Chapter Five (especially by the British,[128] the Japanese,[129] and other governments[130]), and the Massachusetts Burma law.[131] Further examples include recent foreign government protests against U.S. state procurement practices and U.S. state standards and labeling requirements, included in complaints about U.S. barriers to trade.[132] In addition, several countries have tried to subject U.S. state treatment of foreign investors to the disciplines of the proposed Multilateral Agreement on Investment and to the disciplines of the North American Free Trade Agreement.[133]

Foreign-domiciled MNEs can also lobby their home governments to present their case through diplomatic channels before the U.S. federal government and international organisations. They can try to convince policymakers that any reduction in their business activities in the U.S. from diplomatic sanctions over a subfederal policy will harm the U.S. national economic interest.[134] These companies also have a stronger legal argument than domestic-domiciled companies against state laws which violate international norms

since they can argue that such laws threaten the foreign policy of the U.S. by impeding the flow of foreign commerce.

ii) Economic

Businesses are able to threaten diminished investment or trade with a U.S. state enforcing unpopular tax laws, either because the regulations actually make business with the state prohibitively expensive compared to other locations, or in order to more forcefully lobby the state to change its regulations by stressing the company's importance to the local economy. At the same time, companies can promise increased investment and trade if a U.S. state will change its regulations, even promising certain types of jobs or other resources which are particularly important to the local economy. Politicians may be influenced to change their position on state regulations in order to be able to claim that they have provided more jobs and investment for their constituents, and companies can also directly contribute money to the state election campaigns of politicians which support their position.

5) Foreign governments

a) Actors

Countries which are home to a large number of firms investing in the U.S. are often directly involved in seeking to influence U.S. subfederal laws which violate international norms. The **Japanese government** and the **member states of the European Union** protested the U.S. states' use of the WWC method of unitary taxation: they felt the method harmed MNEs from their countries by forcing them to pay large tax bills and subjecting them to a risk of double taxation. Since no overarching mechanism operates between countries to ensure a company is not double-charged on its profits by different jurisdictions, MNEs operating in California ran the risk of paying money on one set of profits to several tax jurisdictions using competing transfer pricing regulations.

Foreign governments viewed U.S. state use of the WWC method as discriminatory to foreign-based MNEs: since foreign-domiciled MNEs generally conducted a larger part of their business outside of the jurisdiction of U.S. states, their

governments contended they were subject to a higher risk of double taxation. In addition, foreign governments argued that the WWC method subjected foreign-based MNEs to greater compliance costs, since they had to overcome currency fluctuations and language barriers, and were forced to gather financial information from countries whose accounting standards and legal climates differed from the U.S.. Further, it was felt that the method, by effectively penalising firms which lost money in the U.S. while profiting overseas, inhibited the spread of new foreign startup companies, which typically lose money during their first years in the U.S.

The British government, moreover, saw the unitary issue as a matter of principle, fearing that use of the method would spread worldwide if the U.S. federal government, previously seen as the standard-bearer for the ALS, allowed the use of an alternative method to continue at the subfederal level.[135] Other foreign governments also appeared concerned that the U.S. federal government might be weakening in its support for the ALS.[136]

b) Agendas

The governments of the U.S.'s major trading partners, in common with the U.S. federal government, wish to encourage a uniform international tax system to promote global economic growth through increased international trade and investment. To this end, the arm's length standard has been widely promoted as the international norm for tax jurisdictions to use in evaluating MNE transfer pricing policies. Subfederal use of the WWC method created concern among foreign governments that the U.S. was weakening in its support for the ALS. This was particularly worrisome since America had led efforts to develop a tax treaty network among the major trading countries after W.W.II.,[137] a network which enshrined the use of the ALS as the international norm.

Fear among foreign governments that U.S. support for the ALS was weakening grew after 1986 revisions of IRS transfer pricing regulations included the formulary apportionment-style profit splitting and comparable profit interval methods as optional methods to use in evaluating transfer prices. This was criticised by European governments, who felt it showed the U.S. was not fully committed to the arm's length

standard. At the same time, European governments also criticised the U.S. government for applying the arm's length standard too rigorously and being out of sync with the Europeans' more relaxed application of transfer pricing rules.[138] Americans countered privately that European governments were only holding their transfer pricing regulations to the arm's length standard without exception because they were not enforcing their regulations as strictly as the IRS.

The European, British, and Japanese governments were concerned that the use of the WWC method by any U.S. state would prompt other states to adopt the method. Such a spread at the U.S. state level, coupled with the optional use of formulary apportionment-type methods at the federal level, might lead to the establishment of the WWC method as an alternative standard for evaluating transfer pricing practices in the U.S. This, the governments felt, would worsen the global trade and investment climate by creating uncertainty for international business. In addition, it was feared that widespread adoption of the WWC method in the U.S. would encourage developing countries to begin using the method, which would disadvantage all MNEs by taxing them on an income base which included their much more expensive factors of production in developed countries. Moreover, all governments were concerned with the extraterritorial nature of the WWC method, and the risk of double taxation from having two systems of evaluating transfer prices in use.

Of all the European governments, the British were the most active lobbyists on the California unitary tax issues, since the British were the largest foreign investors in California during the early 1980s, when the debate took place (see Figure 14 in Chapter 4, p. 164) and since the British government in particular was concerned with stopping any spread of the worldwide unitary principle of taxation: the UK had seen itself as a standard-bearer in pushing for adoption of the arm's length principle prior to this debate, and was particularly concerned with upholding the arm's length standard in all jurisdictions, even subfederal ones.

c) Assets

i) Political

In negotiating with the U.S. federal government, foreign governments have as political assets their prestige and standing within the international system, their power within international organisations to press other countries to change their policies, and the U.S. federal government's need to maintain good relations with them to pursue American goals in other areas. When dealing with U.S. states, foreign governments have the additional asset of the novelty of their presence at this level of government, which may accord them greater attention. However, they can also be at a disadvantage at the subfederal level, since U.S. state governments have less experience than the U.S. federal government negotiating with foreign governments, and fewer institutions developed to interface with them effectively.

ii) Economic

Foreign governments can threaten to revoke bilateral tax treaties, or other bilateral economic treaties, if the U.S. federal government does not prevent U.S. states from propagating regulations which violate international norms. In addition, governments can threaten diminished investment and trade from their country by imposing sanctions or penalties against the United States as a whole or against specific offending states. On an informal basis, they can lend credence to MNE threats to lessen trade and investment with offending countries by encouraging a boycott by companies from their country. They can also refuse to grant market access or regulatory concessions to U.S. MNEs seeking to invest in their country, or exclusively to MNEs headquartered or doing business in an offending U.S. state.

6) International organisations

a) Actors

The Organisation for Economic Cooperation and Development (OECD) is the main intergovernmental forum for consultation and cooperation on economic and social policies, including taxation practice, among the free-market democracies of North America, Western Europe, and the Pacific.[139] Most countries bilateral tax treaties are

based on the OECD Model Tax Convention (revised in 1994, 1995, 1997, 2000, and 2003), which seeks to avoid double taxation "by allocating taxing rights between the resident and source countries and by requiring the former to eliminate double taxation when there are competing taxing rights.[140] There are close to 350 tax treaties between OECD member countries, and another 1500 worldwide which are based on the Model Tax Convention.[141] Article 9 of the OECD Model Tax Convention on Income and on Capital lays out the basis for the adoption of the arm's length standard in international tax arrangements, and for the treatment of MNE group companies as separate entities, instead of as a unitary group. The OECD model in this area has remained the same since 1963, and has provided the basis for the approach to transfer pricing policies used by most countries.

The OECD Model Tax Convention endorses the primary use of the ALS method, and allows countries to use formulary apportionment methods only if they have been customary in a country and if their results are not too different from those obtained under the ALS. The Model Convention also provides for non-discrimination in taxes, since Article 24 of the Model forbids OECD members from imposing any tax requirements on companies from other OECD countries more burdensome than those they impose on their own domestic companies.[142] The reporting requirements of the WWC method have been condemned by foreign governments under Article 24 as effectively imposing a more burdensome tax requirement on foreign companies.[143]

The 1979 OECD report "Transfer Pricing and Multinational Enterprises" rejected the use of worldwide unitary formulary apportionment except to verify an arm's length price or in "specific bilateral situations" where other methods give rise to serious difficulties and the concerned countries are able to agree on a common approach to the use of formulary apportionment.[144]

In 1984, the OECD's follow-up report, "Transfer Pricing and Multinational Enterprises: Three Taxation Issues", announced guidelines for specific parts of the banking sector, the problem of corresponding adjustments, and the handling of central management and service costs. In 1984 and 1985, the OECD Working Party on Taxation

and Multinational Enterprises examined the use of the WWC method in several U.S. states and submitted a report to the U.S. administration pointing out problems which resulted from the worldwide unitary approach.[145] In 1987, the OECD published a further report, "Thin Capitalisation", which dealt with MNE tax avoidance through manipulative interfirm financing methods. In April 1993, the OECD's Committee on Fiscal Affairs established a special task force to revise the 1979 transfer pricing standards.

The OECD special task force report of July 1995, "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations", stated that the OECD did not "consider global formulary apportionment a realistic alternative to the arm's length principle".[146] Instead, the report stated that a global consensus had formed in favour of the arm's length principle, and that OECD member countries supported this consensus.[147]

The 1995 report thus rejected worldwide taxation much more specifically than in previous OECD reports, and explicitly distinguished it from profit split methods. Profit splitting was to be allowed as a tax method of last resort, and its use was strictly curtailed. However, the permission given for use of the profit split method in any circumstances was itself condemned by French and German business, with support from their governments, as a breach of the arm's length standard and a capitulation to U.S. government lobbying on behalf of its revised 1993 federal transfer pricing regulations which allowed for the use of profit splitting and the comparable profit interval method, both considered by the Europeans as formulary apportionment in essence.

The United Nations model income tax treaty also prescribes the use of the arm's length standard.[148] **The World Trade Organisation (WTO)** of the United Nations, which was created in April 1994, was not in existence at the time of California's unitary tax controversy, but its predecessor, the **General Agreement on Tariffs and Trade (GATT)** was. The GATT had no explicit rules on taxation, but tax policy was seen as falling under GATT rules requiring national treatment and guaranteeing Most Favoured Nation (MFN) status. The former prohibits a government from favouring its own citizens and enterprises over foreign citizens, and the latter prohibits favouring the producers of one nation over those of another. These principles were seen as applicable only to indirect

taxes, such as sales, use and excise taxes, not direct income or capital-based taxes.[149] Therefore, the GATT did not issue an opinion on the use of formulary apportionment methods. However, in December 1981, in conjunction with a European Community complaint about the operation of the United States' Domestic International Sales Corporations (DISCs), the GATT Council ruled that Article XVI: 4 of the General Agreement, which outlaws export subsidies, required that arm's length pricing be observed; it therefore imposed parameters on the prices that may be charged between related parties in export transactions, but did not prohibit "the adoption of measures to avoid double taxation of foreign source income".[150]

As a result of this GATT ruling, the EC and U.S. negotiated an agreement in 1981 which replaced DISCs in the U.S. with Foreign Sales Corporations (FSCs), foreign corporations responsible for certain sales-related activities of goods produced in the U.S. for export. The U.S. allowed a portion of a FSC's export-related foreign-source income to be exempted from U.S. income tax. However, in June 1999, after further protests from the European Union, a WTO panel ruled this exemption was also a prohibited export subsidy under the WTO Subsidies Agreement since it created a financial benefit to companies by foregoing government revenue that would otherwise have to be paid.[151] The U.S. government, however, claimed the 1981 EC-U.S. Agreement excluded Foreign Sales Corporations from the GATT list of prohibited export subsidies since FSCs were designed to prevent foreign-source income from being subject to double taxation.

Since the 1999 WTO ruling, the U.S. Congress passed a law modifying the tax treatment of FSCs; the EU has stated this modification is still unacceptable. The WTO panel reviewing the U.S. FSC replacement law ruled on June 22, 2001 that the new law did not bring the U.S. into compliance with its WTO subsidy commitments. On October 15, 2001, the U.S. appealed this decision, but on January 14, 2002 the Appellate Body upheld the decision that the American FSC replacement law violated WTO disciplines on subsidies. The WTO Dispute Settlement Board then adopted the Appellate Body report. The EU has received WTO authorisation to retaliate against US$4 billion of U.S. merchandise imports annually, the maximum amount allowed by the WTO in such a

case.[152] The U.S. Congress is currently trying to pass FSC/ETI replacement legislation to that comply with the WTO ruling.

The GATT system has traditionally held a stricter view than U.S. law on the discriminatory effects of U.S. state legislation. For example, in the "Beer II" case, a U.S.-Canada GATT panel ruled in 1992 that Minnesota tax preferences for small beer makers, allowable under the U.S. Constitution because they only favoured in-state companies by default, since the tax was conditioned solely on the size of the brewery and was neutral with regard to the location of the business, were in violation of GATT national treatment rules because they discriminated against large Canadian beer producers.[153]

b) Agendas

International organisations such as the OECD and the GATT, designed to promote the free flow of international trade and investment, seek to encourage a uniform international tax system in order to facilitate more international trade and investment. In pursuit of their goal of uniformity, they have promoted the arm's length standard as the international norm, not only for ideological reasons about the superiority of this method, since it taxes companies according to national legal boundaries, but in large part because the standard is already in widespread use. In their promotion of the ALS, international organisations sought to stop any U.S. state use of the WWC method for fear it might encourage the spread of an alternative transfer pricing standard and worsen the world trade and investment environment by creating a climate of uncertainty for business.

c) Assets

International organisations which regulate trade and investment establish guidelines and make public pronouncements to encourage national governments to enshrine international norms in their policies, providing political support to national legislation which embodies these norms. International organisations can also authorize retaliation by member countries against a country which violates international norms by suspending or withdrawing economic concessions agreed to by signatory members. In addition, the member countries of these organisations can seek to enforce an agreed-upon

international norm outside of the organisation's domain by threatening diminished trade and investment to or sanctions against a country which violates its rules.

The OECD's main functions are policy surveillance and policy dialogue. The OECD has no direct enforcement powers over either governments or companies, but operates a consultation mechanism with regards to its Guidelines, a code of conduct for multinational companies, through the Committee on International Investment and Multinational Enterprise (CIME), a management group associated with the OECD. However, this committee has left the dissemination of its opinions to national governments.[154] Its codes are designed to be implemented through peer review and pressure.

Although the Contracting Parties to the GATT could, under Article XXIII, authorise the offended nation to retaliate against a country which had not honored a GATT decision by withdrawing or suspending concessions, its decisions could be ignored, and often were, in favour of compromises or political solutions.[155] GATT dispute settlements operated on the principle of 'consensus' whereby a single member could exercise a veto, including the defendant. This meant GATT's enforcement powers over national governments were very weak, took a long time to adjudicate, and were often viewed as overly politicised by member countries.[156] Moreover, GATT provisions had generally been regarded as only applicable to subnational governments under GATT Article XXIV:12, which provided that "(e)ach contracting party shall take such reasonable measures as may be available to it to ensure observance of the provisions of this Agreement by the regional and local governments and authorities within its territories".[157] Thus, the U.S. government had to implement GATT rulings on U.S. state laws.

In April 1994, after the debate over California's unitary tax method had ended, the General Agreement on Trade in Services (GATS) was created. Unlike the GATT, the GATS implicates direct taxes, such as income or capital-based taxes, and allows countries to use different methods of direct taxation on companies from other member countries, provided that the difference in treatment is intended to result in an equitable imposition of

taxes on companies from all the GATT member states.[158] This may include allocating or apportioning a company's income and profit in order to protect a member country's tax base.[159] GATS is also explicitly made applicable to subnational policy regulations,[160] since GATS Article I:3(a) defines "measures by Members" as meaning "measures taken by...central, region or local governments and authorities".[161]

The World Trade Organisation, created in 1994 as the umbrella organisation of the GATT and the GATS, established a Dispute Settlement Body (DSB) whose procedures are explicitly made applicable to measures taken by subfederal governments or authorities located within the territory of a WTO member.[162] The WTO dispute settlement mechanisms, unlike those of the GATT, operate on the principle of 'reverse consensus', whereby a veto of any decision requires unanimous support among all WTO members. There is also a structured setting of timetables for completing a case. Initial rulings are made by a panel established by the Dispute Settlement Body, with the possibility of appeals to an Appellate Body based on points of law. The panel report, including any changes made during the appeals process, is then passed to the Dispute Settlement Body for adoption. The losing party must report on its full implementation of the panel report within a "reasonable period of time", or negotiate compensation with the victorious party.[163] If no agreement is reached on compensation, the Dispute Settlement Body may authorise the winning country to implement retaliation, such as higher tariffs, against the offending country.[164]

U.S. states lobbied intensively to guarantee state interests in the federal legislation implementing the Uruguay Round Agreements, which established the GATS and the WTO, into U.S. law. As a result, the U.S. Uruguay Round Agreements Act declares that only the U.S. federal government can bring a court case against a state law for being inconsistent with the Uruguay Round Agreements.[165] In addition, the Statement of Administrative Action of the Uruguay Round Agreements Act holds that the Agreements "do not automatically 'preempt' or invalidate state laws that do not conform to the rules set out in those agreements - even if a dispute settlement panel were to find a state measure inconsistent with such an agreement".[166] Moreover, the Statement of Administrative Action makes clear that "the Attorney General will be particularly careful

in considering recourse to this authority where the state measure involved is...a state tax of a type that has been held to be consistent with the requirements of the U.S. Constitution".[167] This is seen as a direct reference to state use of the WWC tax method.

Further, the U.S. Trade Representative's office submitted a formal list of U.S. reservations to the GATS which withholds U.S. agreement to national treatment of subnational taxes if state taxes provide favourable treatment to in-state services. The "Schedule of Specific Commitments for the U.S." of June 29, 1994 directly assures states of their freedom to tax foreign corporations under formulary apportionment methods by stating that subfederal tax measures which discriminate against companies from other WTO member countries by allocating or apportioning their income in order to protect a subfederal tax base are reserved from the scope of the GATS by the U.S.[168]

7) Summary

This chapter has described the actors involved in lobbying to change U.S. state tax policies, focusing on the actors which took place in the debate over California's worldwide combined unitary tax method. It has described each actor's role in influencing U.S. state tax policy, its agenda on subfederal tax policies in general and with regards to subfederal use of the WWC method, and the economic and political assets each actor had at its disposal during the debate over California's unitary tax method. It has thus described the first three components of the model being built to evaluate state-firm bargaining at the subfederal level: the actors, their agendas, and their political and economic assets.

Chapter Three supports the hypothesis put forth in Chapter One that powerful U.S. states such as California can maintain regulatory standards at odds with federal and international norms. As this chapter has made clear, the U.S. courts have proved ambiguous in their evaluation of the legality of international economic activism by states, which is less constitutionally clear-cut than U.S. state international political activism. The Tenth Amendment of the U.S. Constitution holds that states are not bound by federal laws or international treaties unless it becomes apparent that state laws directly interfere with

international commerce or U.S. foreign policy. Court rulings have declared that such 'direct interference' is clear only when state laws diverge from specific congressional laws. However, Congress has joined the U.S. courts in its reluctance to consistently constrain states which violate international norms. U.S. entrance into multilateral agreements which seek to constrain state regulations have been followed by broad exceptions for state policies in the federal legislation implementing these agreements into U.S. law.

Federal reluctance to control U.S. state governments when their economic actions have adverse international consequences increases the power of U.S. state governments to bargain directly with foreign governments and multinational enterprises as actors in the international arena. This chapter thus provides support to the thesis' second hypothesis that during state-firm bargaining over subfederal economic regulations, the U.S. federal government will not always be the preeminent negotiating channel for international actors.

This chapter has defined the relevant actors in the debate over California's unitary tax, their policy agendas as they approached the debate, and the economic and political assets they had at their disposal. Chapter Five will be a detailed factual account of the debate over California's unitary tax. Chapter Six will then evaluate how effectively the actors deployed their political and economic assets through various channels of negotiation during the debate, thereby completing the model of state-firm bargaining at the subfederal level in the case of California's unitary tax. The following chapter will now examine the state of California as a lead actor in the debate over U.S. subfederal taxation of MNEs and in U.S. state activism in the international economic arena.

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[1] Hocking, 1999, p. 20. Picciotto, p. 1021.
[2] Braithwaite and Drahos, 2002.
[3] Shuman, 1992, p. 164. 1952 ruling, *Schwartz* v. *Texas*.
[4] Hellerstein and Hellerstein, 1997, p. 188.
[5] Ibid., p. 299.

[6] Ibid., p. 189. *Northwestern States Portland Cement Co.* v. *Minnesota*, 358 U.S. 450, 457-458, 79 S.Ct. 357 (1959).
[7] Ibid., p. 302-303. *Aloha Airlines, Inc.* v. *Director of Taxation*, 464 U.S. 7, 104 S.Ct. 291 [1983].
[8] Ibid., p. 302-303. *McGoldrick* v. *Gulf Oil Corp.*, 309 U.S. 414, 60 S.Ct. 664 [1940] and *Xerox Corp.* v. *County of Harris*, 459 U.S. 145, 103 S.Ct. 523 [1982].
[9] Ibid., p. 304.
[10] J. Dwight Evans, 1994, p. 5. *United States Steel Corp.* v. *Multistate Tax Commission*, 434 U.S. 452; *Exxon Corp.* v. *Wisconsin Department of Revenue*, 447 U.S. 207; *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425.
[11] Hellerstein and Hellerstein, 1997, p. 3.
[12] Ibid., p. 336.
[13] Ibid., p. 332. *Miller Bros Co.* v. *Maryland*, 347 U.S. 340, 344-345, 74 S.Ct. 535, 539, 93L.Ed. 744 (1954).
[14] *Butler Bros.* v. *McCoglan, 315 U.S. 501*; *ASARCO Inc.* v. *Idaho Tax Commission, 458 U.S. 307.*
[15] 430 U.S. 274, 279.
[16] 441 U.S. 434, 451.
[17] Shuman, 1992, p. 166.
[18] Ibid., p. 155.
[19] Shaviro, 1993, p. 70.
[20] 133 U.S. 258.
[21] Scheiber, 1993, p. 80.
[22] 299 U.S. 304.
[23] Ibid.
[24] U.S. Department of the Treasury website, 2003, citation 1.
[25] See Appendix 14 for a further discussion of U.S. Internal Revenue Service revisions to its use of the arm's length standard.
[26] U.S. Department of the Treasury website, 2003, citation 2.
[27] U.S. Department of the Treasury website, 2003, citation 3. As well, the Office of the International Tax Counsel (ITC) of the Treasury is responsible for negotiating and reviewing income tax and estate and gift tax treaties with foreign countries and coordinating tax treaty matters with the State Department and Congress. ITC attorneys develop international tax legislation proposals and review and assess all international tax bills, coordinating with Congressional staff to ensure the passage of their tax proposals.
[28] Interview #24.
[29] Ibid.
[30] U.S. Department of State website, 2003.
[31] Tax Notes, February 1986, p. 682.
[32] Mansfield, 1983, p. 243.
[33] O'Toole, 1993, p. 22.
[34] Elazar, 1987.
[35] Ibid.
[36] Hellerstein and Hellerstein, 1997, p. 3.
[37] Ibid.
[38] Ibid., p. 406.
[39] Ibid., p. 407. Multistate Corporate Income Tax Guide (CCH) 125 (1997).

[40] Shuman, 1992, 162.
[41] Ibid.
[42] Interview #10.
[43] Shuman, 1992, p. 168.
[44] Ibid., p. 169.
[45] Ibid.
[46] Hellerstein and Hellerstein, 1997, p. 189.
[47] Ibid., p. 472.
[48] Ibid., p. 472. *Nippert* v. *Richmond*, supra, 327 U.S., at 425, 66 S. Ct., at 590.
[49] Shaviro, 1993, p. 95.
[50] Hellerstein and Hellerstein, 1997, p. 560.
[51] Ibid., p. 560. See Appendix 1 for a list of states which have adopted UDITPA, the Multistate Tax Commission Regulations, and the Multistate Tax Compact.
[52] O'Toole, 1993, p. 14.
[53] Interview #18.
[54] Hellerstein and Hellerstein, 1997, p. 566.
[55] Ibid. See Appendix 1 for a list of states which have adopted UDITPA, the Multistate Tax Commission Regulations, and the Multistate Tax Compact.
[56] Interview #18.
[57] Multistate Tax Commission website, 2003.
[58] Interview #38.
[59] Interview #18.
[60] Multistate Tax Commission website, 2003.
[61] Huff, 1979.
[62] 434 U.S. 452, 98 S.Ct. 799 [1978].
[63] Hellerstein and Hellerstein, 1997, p. 566.
[64] Ibid., p. 566. *Virginia* v. *Tennessee*, 148 U.S. 503, 519, 13 S.Ct. 728 (1893).
[65] Interview #39.
[66] Interview #7.
[67] Western Governors' Association website, 2003.
[68] Western Governors' Association, 1997. This was incorporated in Resolution 77-033 to the U.S. Senate Foreign Relations Committee, recommending the Senate not validate the U.S.-UK Tax Treaty.
[69] Federation of Tax Administrators website, 2003.
[70] National Conference of State Legislatures website, 2003.
[71] Brief of the Council of State Governments et al, the Barclays/Colgate case. January 19, 1994.
[72] Council of State Governments website, 2003.
[73] Brief of the Council of State Governments et al, the Barclays/Colgate case. January 19, 1994.
[74] Citizens for Tax Justice website, 2003.
[75] Ibid.
[76] See Appendix 2 for a list of states which used the WWC unitary method of taxation and the time period use of the method covered.
[77] Interview #10.
[78] Interviews #18, #10.
[79] Interview #10.

[80] Interview #18.
[81] See Appendix 16, Chart 9.
[82] Interviews #4 and 7.
[83] Interviews #12, #13.
[84] Howard, 1993, p. 173.
[85] O'Toole, 1993, p. 24.
[86] Wrightson, 1993, p. 244.
[87] See Appendix 5 for data on U.S. Gross State Products compared to the Gross National Products of various countries.
[88] Kincaid, 1984, p. 113.
[89] 441 U.S. 434 (1979).
[90] 441 U.S. at 446.
[91] Committee on State Taxation, 1980.
[92] Ibid.
[93] Interview #14.
[94] Interview #21.
[95] Ibid.
[96] U.S. Council for International Business website, 2003.
[97] U.S. Council for International Business, 1993.
[98] Ibid.
[99] Interview #8.
[100] Muchlinski, 1995, p. 295.
[101] Helfrich-Laubrock, 1986, p. 403.
[102] Interview #13.
[103] National Association of Manufacturers website, 2003.
[104] National Association of Manufacturers, 1993.
[105] Interview #13.
[106] The Business Roundtable website, 2003.
[107] Interview #19.
[108] Kamuf, 1987, p. 6.
[109] The Tax Foundation website, 2003.
[110] Ibid.
[111] Tax Executives Institute, 1987.
[112] McCormally, 1997.
[113] Ibid.
[114] Ibid.
[115] Interviews #25 and #36.
[116] The Official Journal of The European-American Chamber of Commerce, 1996.
[117] Interview #4.
[118] Ibid.
[119] National Foreign Trade Council website, 2003.
[120] National Foreign Trade Council, 1985.
[121] DuBos, 1986.
[122] Confederation of British Industry, February 1985, citation 2.
[123] Unitary Tax Campaign.
[124] Organisation for International Investment, 1985.
[125] Interview #8.

[126] Eggleston, 1980.
[127] Guy, 1980.
[128] p. 174-75, p. 192-193, p. 203, p. 207, p. 220-221, p. 225-228, p. 253-254.
[129] p. 176, p. 202-203, p. 206, p. 228, p. 253-254.
[130] p. 176-178, p. 221, p. 228, p. 253-254.
[131] p. 283-285.
[132] p. 286.
[133] p. 286-88.
[134] Interview #4.
[135] Interview #50.
[136] Ibid.
[137] J. Dwight Evans, 1994.
[138] Interview #4.
[139] U.S. Council for International Business, 1993.
[140] Organisation for Economic Cooperation and Development website, p. 1, 2003.
[141] Ibid.
[142] Koning, 1984, p. 296.
[143] Ibid.
[144] Hay, Horner and Owens, 1994. p. 519.
[145] Working Party No. 6.
[146] Organisation for Economic Cooperation and Development, III-20.
[147] Ibid.
[148] Tax Notes, February 1986, p. 682.
[149] Walter Hellerstein, 1995, p. 4.
[150] Barton and Fisher, 1986, p. 480-481.
[151] World Trade Organisation, 2000, p. 61.
[152] Organization for International Investment website, 2003.
[153] Horvath, 1996. See Appendix 9 for a further discussion of the Beer II case.
[154] Barton and Fisher, 1986, p. 892-895.
[155] Ibid., p. 164 and p. 453.
[156] Ibid., p. 164.
[157] Walter Hellerstein, 1995, p. 4.
[158] World Trade Organization, 2000, p. 16.
[159] Ibid., p. 19.
[160] Walter Hellerstein, 1995, p. 4.
[161] Ibid.
[162] Ibid. Article 22:9.
[163] World Trade Organization website, Article. 21.3.
[164] Ibid.
[165] Walter Hellerstein, 1995, p. 7. 102(b)(2).
[166] Ibid.
[167] Ibid. Supra note 42, at 18.
[168] Ibid., p. 8. U.S. GATT Reservations para. 3.

Chapter 4: The State of California

1) Introduction

The previous chapter described the actors who took place in the debate over California's worldwide combined unitary tax method. Chapter Four will now examine the state of California as a lead actor both in the debate over U.S. subfederal taxation of MNEs and in U.S. state activism in the international economic arena. It will describe the state's political economy in order to provide a better understanding of the subfederal setting for the unitary tax debate and to examine the state of California as an actor in the bargaining process. This chapter will analyse California's political and economic structure and its political and economic assets. It will follow Hocking's definition of significant factors in determining a non-central government's involvement in multilayered diplomacy: its physical location within the federal system (core vs. periphery regions of political and economic power), international linkages (geography, transborder relations, and cultural links), general resources (which include political culture and membership in cooperative mechanisms such as the National Governors' Association),[1] bureaucratic resources, the degree of asymmetry within federal systems, and the powers assigned to non-central governments within the federal system.[2]

Chapter One asked the question: What capabilities do U.S. states possess when their economic regulations conflict with international norms? California has the largest U.S. state economy and one of the largest economies in the world. It is a leader in key technology and service industries, and is highly influential culturally. Further, as the largest exporting state and home to the most foreign direct investment in the U.S., it is interlinked with the international economy. The state has developed government agencies to assist its businesses internationally and a proto-trade policy to promote its unique economic interests. California also holds strong political assets. Its political structure is

highly developed and strongly independent, and California is an important political force within the U.S. federal system.

As we shall see, California enormous political and economic assets helped convince the U.S. federal government to allow the state to continue to use a tax method at odds with federal and international norms. The legal ambiguity inherent in U.S. federalism, described in Chapter Three, combined with California's strong political and economic assets to allow the state to defend its economic regulations against international and federal protests. Therefore, this chapter will lend support to the hypothesis put forth in Chapter One that powerful U.S. states such as California can maintain regulatory standards at odds with federal and international norms. However, it is important to note that as California became more economically dependent on foreign investment in the mid-1980s and went into a recession in the early 1990s, the state's economic assets depreciated enough that California modified its unitary tax regulations in order to continue to attract foreign business to its jurisdiction.

This chapter also lends support to the second hypothesis put forth in Chapter One, that international forces do not always have their primary policy impact at the national level. This is particularly true in the case of California, one of the largest economies in the world, which maintains extensive international links through tourism, immigration, trade and investment.

Chapter Four will first describe the political structure of California's state government, the state's political culture, its corporate tax authorities, and the development of state institutions to implement California's international objectives. A brief description of California's economy and changes in its economic base, along with the state's economic culture and foreign trade and investment picture, will follow. Chapter Four will then describe California's particular political and economic assets, and how they changed over time. It will conclude by describing California-based lobbying groups which attempted to influence the state's unitary tax reform legislation in 1986 and 1993.

2) Political structure

a) State government

Originally settled by Spain in 1769, California became a province of Mexico in 1822 and was annexed by the United States after the Mexican-American war of 1846. The state government's current powers are rooted in the state constitution, ratified on November 13, 1849. In an unusual reversal of practice, and a precedent of the state's future independence in formulating law, California ratified its state constitution before its formal admission into the United States of America as a territory. The U.S. Congress, divided over admitting another 'free soil' state which did not permit slavery, had repeatedly failed to grant California the territorial status which normally preceded statehood. California was therefore being ruled by laws which existed at the time of the American annexation: a frontier application of Mexican civil law ill-suited to its rapidly growing population. At the suggestion of U.S. President Zachary Taylor, California independently framed a constitution, written in both English and Spanish, and elected a legislature, which then elected two Senators to the U.S. Congress. The Senators went, state constitution in hand, to petition Congress for statehood, which was granted on September 9, 1850.[3]

In 1879, California held a second constitutional convention, led by the Workingmen's political party and small farmers, in hopes of breaking the power of railroad interests which had set up a political machine controlling the state legislature. The new state constitution mandated regulation of big business, although the reform movement died out in the next several years and the railroad interests continued to dominate state-wide politics until the Progressive movement of the early 20th century again weakened the political party system in California.[4]

i) Legislature

The California state government, headquartered in Sacramento, California, has three branches: the legislative, the executive, and the judicial. The California legislature passes laws, appropriates public funds, and confirms or rejects the governor's appointees

to positions in the executive branch of government. The California legislature contains two houses: the Senate, with 40 members, and the Assembly, with 80 members. Both houses have numerous standing committees which put forth legislation on specific issues. Within the California Senate, tax legislation originates in the Senate Committee of Revenue & Taxation. The Senate Committee on Finance, Investment & International Trade and the Senate Budget & Fiscal Review Committee review tax legislation. Within the California Assembly, tax legislation originates from the Revenue & Taxation Committee, and there are corresponding International Trade & Development and Budget & Appropriation committees which review tax legislation. Prior to 1995, during the time of the unitary tax debate, these last two committees were combined in the Assembly Ways & Means Committee.[5] The Senate Revenue and Taxation Committee consists of 9 members and 2 permanent staffers and meets twice a month; the Assembly Committee has 11 members and 2 permanent staffers, and meets weekly. The majority of the members of these committees, along with their chairs, come from the political party which has the majority of seats in each legislative house: in California, both the Assembly and the Senate are typically dominated by the Democratic party.

All state bills are nominated by an 'author', a legislator who submits the bill, and considered by one or more committees in either the Assembly or the Senate. If approved by a majority of a committee's members, the bill goes to the floor for debate by the entire house. If passed, the bill moves to the other legislative house for consideration through the same process of committee and floor votes (see Figure 4 on p. 132 for a diagram of the typical path of legislation in California).

If a legislative house proposes amendments to a bill which the originating house does not agree with, three senators and three assembly members will form a two-house conference to agree on common language. If the conferees do not agree, the bill dies. However, if they present a recommendation for compromise, known as a conference report, and both houses vote to pass the report, the report goes to the governor for signature into law. If either house rejects the report, second and third conference committees may be formed. All state legislation must be approved by both the Senate and

the Assembly and be signed into law by the state governor in order to become law. Appropriation bills, constitutional amendments, and urgency bills require that two-thirds of each legislative house vote in their favour before they become law; all other bills need the approval of a simple majority vote of each house. The governor may veto any bill passed by the legislature; however, a two-thirds vote by both houses can override a gubernatorial veto. According to the California Constitution, most bills go into effect as law on the next January 1st following a 90-day period from their enactment.

ii) Executive

The governor's office, with its agencies and departments, serves as the executive branch of state government. The governor shapes the state budget, appoints key policymakers in the executive and judicial branches, and participates in reapportionment of the legislature and the California congressional delegation.[6] Although many high-level state officers are appointed by the governor upon approval by the legislature, the governor's powers are circumscribed: he shares power with five executive officers who are directly elected and can come from opposing political parties.[7] In addition, his patronage opportunities are limited since the vast majority of positions in the executive branch are filled by the state's civil service system based on merit.[8] Since the executive branch officially only administers and enforces laws the legislature makes, "the policy priorities of the governor cannot be directly imposed". [9] When working with state legislators, governors must rely on their "power to persuade".[10] The governor and his staff initiate, recommend, and influence legislation in an attempt to put the governor's policy agenda into practice. The governor also influences legislation through his veto power and through his ability to submit the state budget, which often has wide-ranging policy implications.

Further, many ideas for statutory changes in the law originate within the agencies or departments of the executive branch. Some statutory changes, such as the implementation of the worldwide combination unitary tax system, are put into practice by the agencies of the executive branch simply upon the approval of the agency's officials; if legislation is required to implement a change in agency practice, the governor's legislative

counsel will either draft a bill or request that a legislator do so. In addition, since many state laws are "broadly drawn",[11] it often falls to the agencies and departments concerned to work out the details of a new law through administrative decisions and regulations.

iii) Judiciary

The state courts, consisting of the justice courts, municipal courts, Superior Courts, Courts of Appeal, and the California Supreme Court, comprise a third branch of state government which enforces the statutes made by the state legislature (see Figure 5 on p. 133 for a diagram of the judiciary structure in California). The California judicial system exists side by side with the U.S. federal court system. The California Supreme Court is the ultimate authority on the legality of state legislation, but the U.S. Supreme Court is the final interpreter of any decisions involving an application of U.S. federal law within the state. The U.S. Supreme Court also rules on whether state constitutions and state laws conform to the federal constitution; state courts are bound by its decisions.[12]

Although the state judiciary is often considered to be removed from political influence, California judges are appointed by the state's governor for their accordance with his political views. Some judges are also subject to recall and public elections, leaving them open to the political process, including influence from special interests.[13] In fact, the California judiciary has been called a 'shadow government' because of its increasing importance in shaping public policy.[14]

iv) Lobbyists

Seeking to influence the state of California are roughly 800 permanent lobbyists in Sacramento, the state capitol. These lobbyists consist of:

- contract lobbyists, who work for almost any client willing to pay their fees
- corporation lobbyists, who work for one company, primarily on bills directly affecting their firms, but who may work in concert with other lobbyists who share their companies' goals, including contract lobbyists
- association lobbyists, who represent groups of firms, agencies or professionals

- public-agency lobbyists, who represent numerous cities, countries, and special districts, as well as state agencies
- public-interest lobbyists, who work on behalf of special interest groups, such as environmentalists, consumers, or women.[15]

In the year 2000, there were 1,024 registered lobbyists and over 350 registered lobbying firms representing some 1,956 paying interest groups in California.[16] In the 1988-1990 California legislative session, $194 million was spent on lobbying the California state government; this increased to $234 million in the 1990-1992 session, and $250 million in the 1992-1994 session.[17]

Figure 4: Typical Path of Legislation in California

Source: League of Women Voters, "Guide to California Government". 1992, p.39.

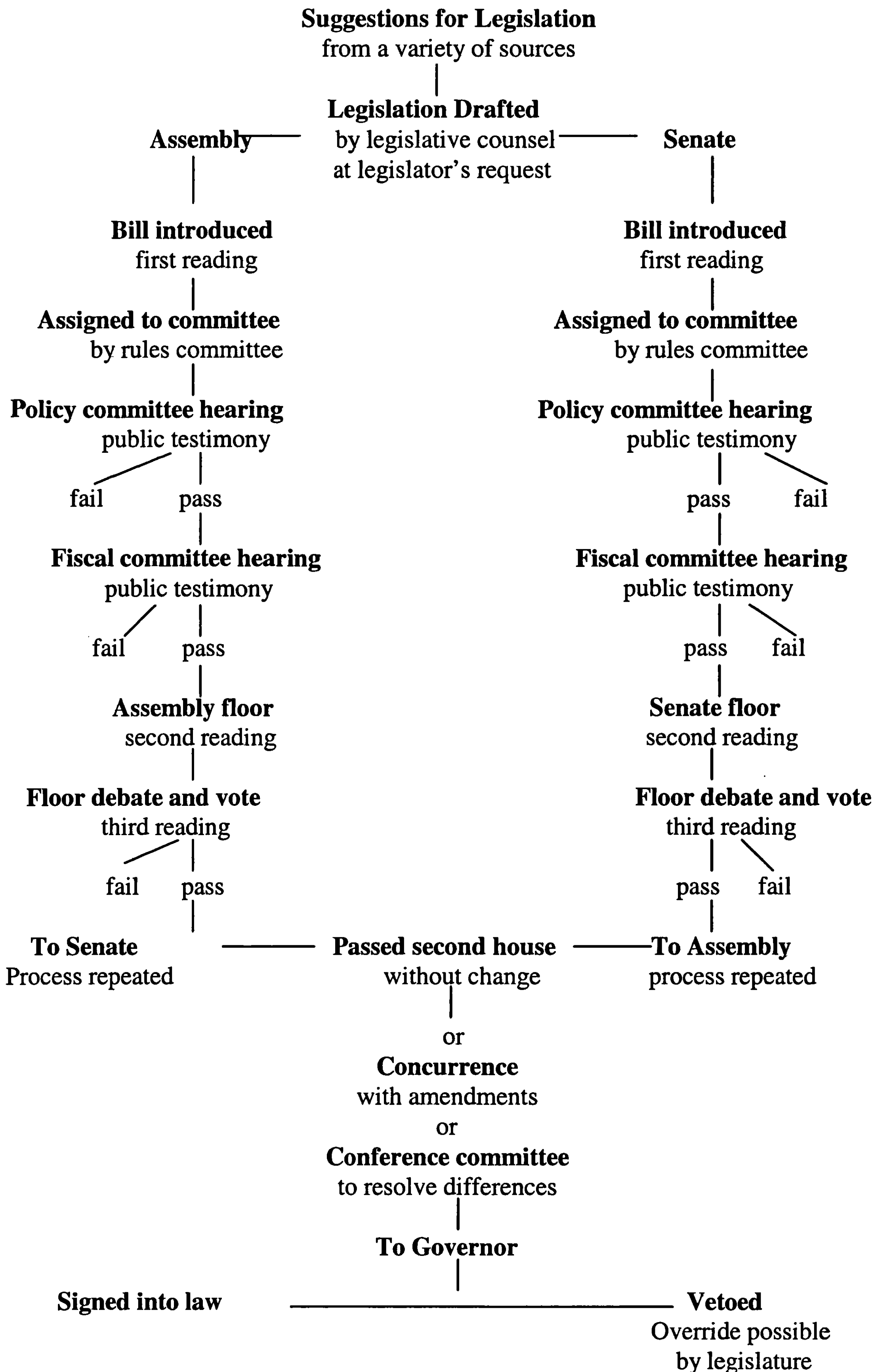
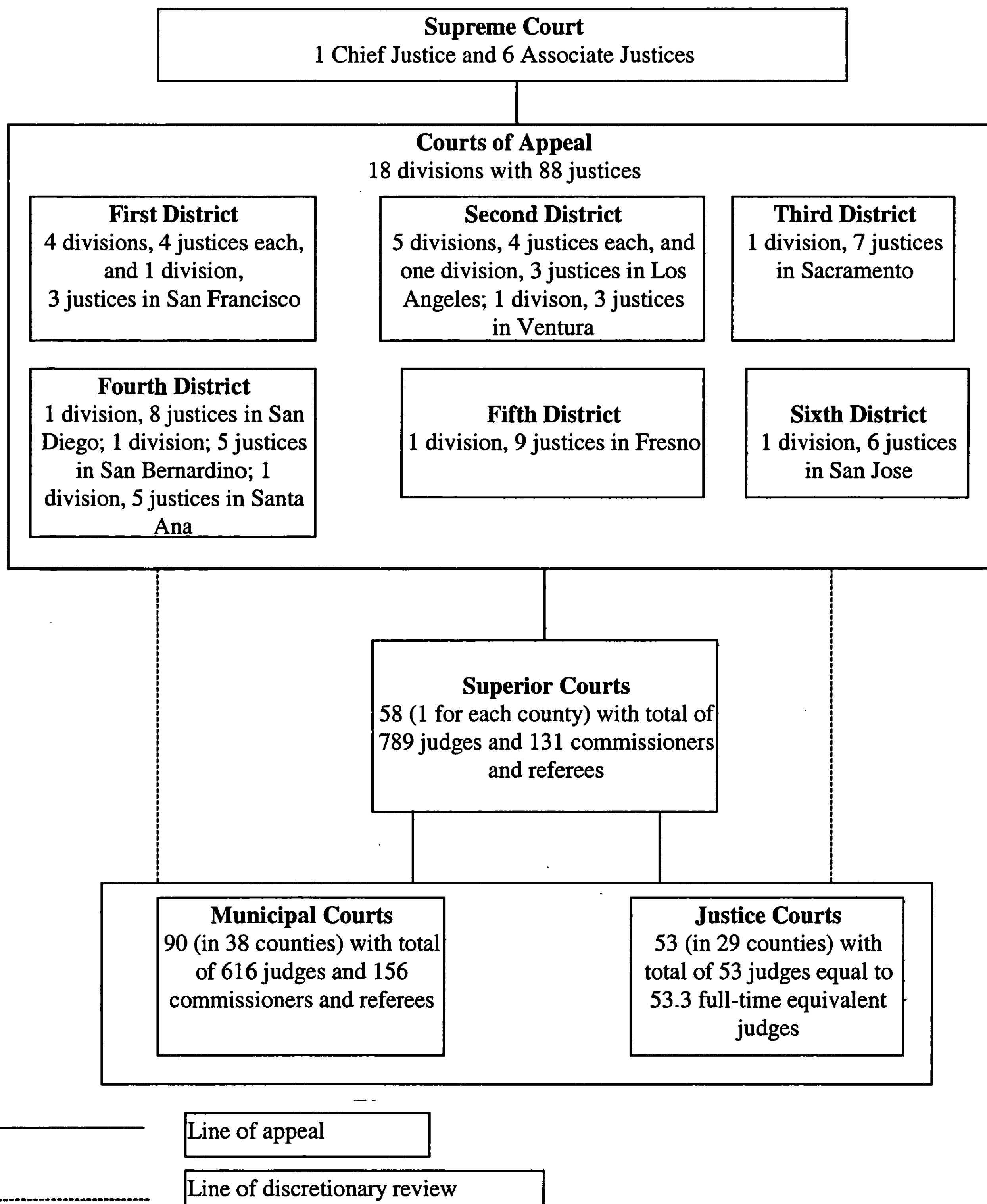


Figure 5: Judicial System in California

Source: League of Women Voters, "Guide to California Government". 1992, p. 59.



The most common political resources lobbyists have "include bureaucratic knowledge, a network of contacts, citizen backing (size of constituency), an ability to make political contributions, and an ability to mount a public relations campaign".[18] Groups that are well-funded and well-organized are most able to decisively persuade politicians on their views.[19]

b) State corporate tax authorities

The California Franchise Tax Board (FTB), created in 1929, is the division of the state executive branch which collects and administers state taxes based on income: personal income taxes and bank and corporation taxes. The board itself is composed of three officers: the state controller, the state director of finance, and the chairman of the state Board of Equalization (BOE).[20] The state controller and the chairman of the BOE are both directly elected, and can come from a different political party than the governor; the state director of finance is appointed directly by the governor.[21] The Franchise Tax Board is expected to be politically neutral. It is to function as a technical body of staff administering tax statutes, advising the state government on the consequences of tax policy changes, providing data, and reviewing revenue projections.

California's bank and corporation tax is called a 'franchise' tax because paying a tax on corporation earnings is required as a privilege of doing business, or 'having a franchise', in the state.[22] A corporation franchise tax is a prepaid tax for the privilege of doing business in the following year, and is measured by the amount of income the corporation earned in the preceding year (Chart 1 in Appendix 16 shows the amount of revenue California received from its bank and corporation tax in the 1980s compared to other sources of tax revenue. Chart 2 in Appendix 16 shows the amount of bank and corporation tax collected during the 1980s from each section of the state's apportionment formula: property, payroll, and sales). The state bank and corporation tax was set at 9.3% of net corporate income at the time of the unitary tax debate; it is currently 8.84%.[23] The FTB has a staff of over 4,000 full and part-time employees, an annual budget of over $200 million, and processes nearly half a million

bank and corporation tax returns each year.[24] The U.S. Internal Revenue Service (IRS) runs annual continuing professional education courses for state examiners and briefs state examiners on international law.

The auditing staff of the FTB has had a poor reputation among the corporations it regulates as being adversarial and inflexible on regulations, and companies have frequently appealed to the board's politically-elected commissioners to override staff "intransigence".[25] Companies which disagree with FTB auditor judgments can protest them by filing an appeal to an FTB notice of proposed assessment; most of these protests enter into administrative hearing processes, handled by auditors, although a small percentage of cases which involve legal issues are addressed by FTB staff attorneys.[26] If a resolution within the FTB is not found on a disputed assessment, taxpayers can file an appeal with the California Board of Equalization (BOE), the appellate body for Franchise Tax Board decisions on income and corporate taxes, which functions as a tax court.[27] If the FTB loses before the Board of Equalization, the matter is settled. If the taxpayer loses the appeal, they can appeal to the California Superior Court, and further to the California Supreme Court and the U.S. Supreme Court.[28]

The Board of Equalization (BOE) is a division of the executive branch of the state government which ensures that property throughout the state is uniformly assessed for taxation, directly assesses the property of railroads and public utilities, and administers state retail sales and use taxes, along with various other direct taxes. The board consists of four members elected from equalisation districts representing areas of the state nearly equal in population and the state controller, the chief fiscal officer of the state, who is directly elected.

When examining where power lies within the California state government, it is important not to discount the importance of the bureaucracy. In the case of taxation, this bureaucracy consists of members of the governor's staff, the Franchise Tax Board, the Board of Equalization, and legislative assistants who work for the Senate and Assembly Revenue &

Taxation committees. There is a great deal of networking among state staff working on specific policy areas, and a large amount of expertise has been built up in the small community which establishes tax policy in California. In particular, staff members of legislative committees generally stay in their positions much longer than their elected supervisors, particularly since the California legislature tends to stay consistently under the control of the Democratic political party. Staffers get relatively little publicity and have less contact with lobbyists than elected legislators.[29] However, they generally have a greater knowledge of many policy issues than their elected representatives, and may feel more passionately about certain technical issues. They are therefore highly influential.

c) Development of state institutions for international relations

Before 1992, the primary state agency which dealt with California's international trade was the Economic Development section of the California Department of Commerce, housed within the state's Business, Transportation and Housing Agency. However, this agency concentrated mostly on California's trade with the rest of the U.S. In 1983, in recognition of California's growing international trade links, the **California World Trade Commission (WTC)** was established as a joint private-public body to create demand for California products overseas, provide assistance in financing exports, communicate the benefits of trade to the California business community, and influence public policy which might affect the state's trade performance. The WTC statement of principles committed the Commission to promote free trade, increase exports, resist curbs on imports, and encourage the state and national governments to remove foreign trade barriers.[30]

In 1992, California Governor Pete Wilson, recognising the growing importance of promoting economic development and developing international links for California's economy, consolidated all of the state bodies dealing with international trade and investment in a new **Trade and Commerce Agency**, headed by a Secretary for Trade and Commerce, who is a member of the governor's cabinet.[31] The agency's mission is to encourage the state's economic development and business competitiveness by promoting state exports and foreign

direct investment, effectively marketing California in the world economy, and pushing for pro-business state policies, regulations, and tax reforms.[32] The Trade and Commerce agency is divided into three functional areas: Tourism, Economic Development, which handles mostly local and domestic issues, and International Trade and Investment. The International Trade and Investment division includes the Office of Foreign Investment, which serves as a liaison with foreign companies, the Office of Trade Policy and Research, which provides trade statistics and advocates state and national policies which promote the development of California businesses, the Office of California-Mexico Affairs, the Office of Export Development, which helps small and medium-sized companies with export marketing services, the Export Finance Office, which provides working capital loan guarantees to financial institutions for the export transactions of small and medium-sized California companies, and the World Trade Commission.[33] The World Trade Commission now primarily functions as an advisory body dealing with policy formation. The WTC often lobbies the U.S. federal government on policy issues of importance to California business: for example, the WTC was very active in promoting the North American Free Trade Agreement.[34]

The International Trade and Investment division of the California Trade and Commerce Agency also contains California's six overseas offices, in Tokyo, Hong Kong, Frankfurt, London, Taipei, and Mexico City, as well as two smaller offices in Johannesburg and Jerusalem.[35] Although California policymakers sometimes refer to these offices as "mini-embassies", in reality their functions are far more limited.[36] Office services vary, but they are designed to help state businesses contact joint venture partners, identify marketing opportunities, assist in trade fairs and investment missions, assist with local import regulations, and serve "as a constant reminder of the commitment of California to international trade and investment".[37]

Within the California legislature, the **Assembly Committee on International Trade & Development**, established in 1987 and reorganised and strengthened in 1997, handles

international trade and foreign policy issues for the Assembly. This committee works with the federal government, notably the U.S. State Department and the U.S. Trade Representatives Office, on state issues which impact U.S. trade policy, from proposed state legislation sanctioning foreign countries on ethical grounds to the inclusion of provisions beneficial to California in multilateral agreements.[38] The committee also oversees all state agencies dealing with international trade and investment, conducts state-wide hearings on international issues impacting California's economy and export potential, and hosts foreign delegations visiting the Assembly.[39] The **Senate Committee on Finance, Investment & International Trade** handles these duties for the California Senate; in addition, **the Senate Committee on Economic Development** occasionally looks at international trade issues. The Senate also maintains its own **Office of International Affairs.**[40]

d) Political culture

i) Individualism and pluralism

California has the most diverse population and geography of any U.S. state, with hundreds of distinct ethnic cultures, and huge economic and racial diversity.[41] California's diverse populations means that politics in California are "robust and no-holds barred.[42] At the same time, the wide variety of competing interests within the state has strengthened the value California's political culture places on individualism and led to "independent-minded voters who refuse to hew to a party line".[43] As a result, the state has a political culture with a strong reliance on direct democracy, policy innovation, and a mistrust of large traditional political influencers such as political parties and big business.[44] As a result, "(i)n politics, as in many other fields, California often acts as the pacesetter".[45]

ii) Isolation

California has long viewed itself as a land apart from the national centers of power located on the East Coast. This remove was most strongly felt during the early years of the state, before the widespread use of air travel and the development of the U.S. highway system in the 1950s. Before the mid-20th century, the Western mountain ranges and deserts provided

a formidable physical barrier to contact with the population centers of the East Coast that was bridged only by the railroads. The relative isolation of California from other parts of the country helped fuel a sense of political independence which contributes to the state's often defiant attitude towards the U.S. federal government.

iii) The North/South divide

California has an enduring political, social, geographic, ethnic and economic split between the northern, southern, and central sections of the state.[46] On the political landscape, Southern California is conservative and Republican, with the exception of Los Angeles; Northern California is generally liberal and Democratic; and the Central Valley is politically split, with Democratic urban counties and Republican agricultural areas. Southern California has shifted since the mid-1970s from a manufacturing economy based on aerospace and shipbuilding to a service economy. Outside of the high-tech belt of Silicon Valley, northern California is mostly rural. The Central Valley is California's heartland: primarily agricultural, with small cities and farms.[47]

These geographical splits, when added to the state's tremendous ethnic and economic diversity, can keep the state from reaching a consensus on important policy issues.[48] Such divisions can even preclude state unity. In a non-binding 1992 referendum, rural northern counties voted overwhelmingly to split the state in two, with a division between northern and southern California. This was followed by legislation calling for a popular vote on splitting California into three independent northern, central, and southern states; this legislation passed the California State Assembly, only to die in the state Senate.[49] Such a move, which now seems unlikely, would have to be approved by the U.S. Congress.[50]

iv) Weak political parties and strong interest groups

California is characterised by weak, ineffectual political party organisations.[51] This is primarily a legacy of measures erected during the state's Progressive Era in the early 20th century which legally limited the role of California's political parties. The Progressives

distrusted politicians and were convinced that political independence was a great virtue. California's system of nonpartisan local elections acts as a deterrent to the development of strong party organisations at the grassroots level; a comprehensive civil service system has limited the ability of political parties to distribute patronage; and the extensive use of initiatives, referendums, and recalls in California have diminished the role of political parties in the formulation of state policy.[52]

California political parties are further hampered by independent voting patterns. Heavy immigration and the mobility of the population do not contribute to stable local political party organisations.[53] These independent voters are more willing to vote for candidates, regardless of party, with ideas similar to theirs.[54] The vast size of the state discourages face-to-face campaigns, making the mass media the major campaign battleground in statewide races.[55] Since mass media-conducted campaigns are highly expensive, money has assumed a pivotal importance in California elections.[56]

With weak state political parties, interest groups have moved in to supply the funding necessary to mount expensive state-wide mass-media campaigns.[57] As a result, California has become known as a strong interest-group state.[58] Interest groups further thrive in California because the state's vast size and diversity tend to thwart the creation of inclusive, broad-based political positions. Instead, the state's complexity drives a more narrow, interest-group dominated agenda.[59] The combination of California's weak political parties and strong interest groups often results in a difficult environment in which to build political consensus and coherent public policy formation.

3) Economic structure

a) Economic boom

After World War II, California experienced a prolonged economic boom which lasted until the early 1990s. Even during the 1970s, when recession plagued the rest of the U.S.,

California's manufacturing employment increased at a rate more than five times the rest of the country. This economic boom shaped California's policy choices; particularly during the boom of the 1980s, when Silicon Valley rose to prominence, the state remained untroubled about its business climate, and convinced its relatively high wages and tax rates were the rewards of its success.[60]

"Historically, the state's remoteness from the industrial states of the East and Midwest caused it, from the beginning, to develop a fairly complex economy, rather than one devoted to a few specialized industries".[61] California's economic boom was originally fueled by a massive military build-up during World War II which transformed the state from an agricultural economy to an industrial powerhouse. The growth in the economy fuelled a growth in the population: the state's population grew by half a million people a year in the twenty-five years following WWII, and California overtook New York as the nation's most populous state in 1963.[62] After World War II, continued U.S. military conflicts and the nuclear arms and 'space race' of the Cold War fueled a boom in California aircraft and electronics firms, turning the state into the uncontested U.S. leader in military and technology production.[63] This military build-up provided the state with a large pool of skilled technical workers, "sowing the seeds of the electronic and computer industries" which grew during the 1980s.[64] However, farming and related activities remain the state's single largest employer. California's warm climate, along with its use of advanced technology and marketing methods, make it the largest food processing employer among the states, and the leading agricultural state in the U.S., a position it has held for fifty years.[65] California is also rich in other natural resources: it is the U.S.'s third-largest oil-producing state, behind Texas and Alaska, and contains large timber reserves.

California's high immigration rate, high caliber universities, and a solid based of skilled technical workers from California's history as a military production center gave the state a deep pool of intellectual talent for the provision of specialised services, particularly in technology and science-based industries.[66] California is recognised as the birthplace of the

Internet, the integrated circuit, the vacuum tube, and the microprocessor. With Silicon Valley, the state leads the world in 'new economy' and computer industries: California is home to such companies as Hewlett Packard, McDonnell Douglas, Intel, Yahoo, Netscape, Sun Microsystems and Cisco Systems.[67]

b) Economic culture

California is so large and diverse, both economically and geographically, that it is difficult to speak of a uniform state-wide business climate.[68] Nevertheless, certain aspects of California's economic culture can be highlighted.

Californians believe they have more entrepreneurial and innovative values than the rest of the country in everything from morality and social class to business and technological innovation.[69] The state's own website asserts that: "America looks to California as its bellwether, as the place where new lifestyles and attitudes begin...California is more than a geographical or political state. It is also a state of mind, a way of life, and an evolving dream".[70]

California contains a unique lure as a destination for economic activity: a free-enterprise economy with the image of a place where exceptional opportunity is possible. "California is an example of what the future has in store for the rest of the nation. It has been the birthplace of many of the world's most significant technology innovations, social trends, and is a model of economic innovation and prosperity".[71] California remains an economically experimental state, a place where nationwide trends originate, and writers on the state's political culture often refer to the phrase "the edge of novelty".[72] This experimentation has expressed itself at the level of enterprises, since the state's economy consists predominantly of manufacturing firms 25 to 50 percent smaller than the national average.[73]

c) Growing internationalisation

From the 1980s to the mid-1990s, the period of California's unitary tax debate, California's links to the international economy grew exponentially. Between 1987 and 1992, California manufacturing exports escalated from $34 billion to nearly $70 billion; from 1991-1993, exports produced more than half of the state's total economic growth[74] (Figure 17 on p.164 shows California's long-term growth in foreign trade share as a percentage of the U.S.). California accounted for 15% of U.S. exports by 1993,[75] making it the lead exporting state: international trade produced 9% of California's 1993 gross state product.[76]

From 1983 to 1993, foreign investment in California increased fourfold.[77] By the early 1990s, California was the leading location for foreign direct investment in the U.S., garnering 20% of total foreign direct investment in the U.S. in 1994.[78] California accounted for a high proportion of foreign investment in real estate, services, and wholesale trade, and a relatively low share of investment in manufacturing.[79]

Although fluctuations in foreign direct investment in California have closely matched national activity over time, the sources of foreign investment have been different for California compared to the country as a whole. In the 1980s and early 1990s, European investments were spread throughout the United States, while Asian investors preferred California by a sizable margin. California has the largest sea and air ports on the West Coast, the largest U.S. state marketplace close to Asia, and close historical and immigration ties with Asia (Chart 8 in Appendix 16 shows the amount of foreign trade passing through California's ports in the 1980s and 1990s). In 1994, European investors in California accounted for 40% of total foreign investment in the state, but constituted 52% of foreign investment in the United States as a whole. However, Asian investments made up 44% of the California total compared to 25% of the U.S. total. By 1997, California was the U.S. window to two-thirds of all import/export activity with Asia.[80]

California's close geographic proximity to both Mexico and Asia also made the state a center for foreign immigration, helping fuel a 25% rise in the state's population between 1980 and 1990.[81] The immigrant pool brought enormous entrepreneurial energy to the state and increased its international ties while diversifying the state's ethnic base.[82] The state sustains major populations of Mexican, Chinese, Filipino, Iranian, Armenian, Asian-Indian, and Vietnamese, the vast majority of them first-generation immigrants: one in four Californians was born outside of the United States.[83]

d) Promoting California's international agenda

The increase of foreign direct investment in California in the 1980s was quickly followed by a recognition of both the need to promote California as a location for international investment, and of how much prominence an economy as large and attractive as California's gave the state at an international level.

In 1986, the California legislature's Joint Committee on the State's Economy and Senate Select Committee on the Pacific Rim held state-wide hearings on "California and the Pacific Rim". That same year, the California Economic Development Corporation, a quasi-official agency composed of local business and academic leaders, issued a study with three dozen recommendations on how the state could benefit from its growing interdependence with the Pacific Rim. The report, "California and the Pacific Rim: A Policy Agenda", stated that the worldwide combined (WWC) unitary tax method discouraged foreign investment in California, and advocated its repeal. Other U.S. states had begun to compete intensely for Japanese investment, and the absence or presence of the WWC method in a state was seen as an easy way for Japanese firms to eliminate states from their list of possible locations.

When California Governor Deukmejian made his first trade promotion trip to Japan in January 1987, he announced the opening of a California trade office in Tokyo. However, he was seen as a latecomer in the competition among U.S. states to attract foreign investment: at the time, 30 other states already had investment promotion offices in Japan. In February

1987, the California Assembly Committee on International Trade and Intergovernmental Relations was formed to lobby for more state trade offices overseas and more money to promote state exports as growing state and national trade deficits focused attention on state trade promotion.[84]

California's Lieutenant Governor McCarty presented a 65-page book entitled "California Trade Policy" at a 1986 meeting of the California World Trade Commission.[85] The report argued that as the state economy becomes increasingly internationalised and shifted from a manufacturing to a service base, the state government's responsibility for promoting economic prosperity and a healthy tax base for state programs now required taking an active interest in international commerce. In addition, the report stressed that because of the "distinctive mix of the California economy", California often had "interests that tend to be distinct from the rest of the nation", necessitating a distinct state international economic policy.[86]

The World Trade Commission, started in 1983, stated that "(w)hat sets California apart from the export promotion efforts of other states is our determination to influence trade policy",[87] and the group claimed several successes in this area: "following two leadership missions to Tokyo...(in 1985)...the Japanese agreed to lower duties on several California agricultural products. We even helped prevail upon Taiwan to toughen its intellectual property rights laws, at last giving relief to California manufacturers of aerospace parts, high-technology equipment, pharmaceuticals, and wearing apparel".[88] In 1986, the WTC presented a list of trade barriers to California products in Pacific Rim countries. This was intended to give information to U.S. federal officials for use in international trade negotiations, particularly the Uruguay Round talks of the GATT.[89] In addition, the Washington D.C. office of the California governor, which lobbied the federal government on behalf of the state, contained a representative of the World Trade Commission who worked to ensure federal negotiators in the international trade rounds addressed the interests of California industries.[90]

In 1993, an article in *Foreign Affairs* stated that "California is so big, and its problems so immense, that it needs its own foreign policy. In an era when economics commands foreign relations, this does not mean embassies and armies, but it does mean more trade offices and state agents in foreign countries, its own relations with foreign nations and a governor and legislature willing to represent the state's interests independently of Washington".[91]

e) California's deteriorating economy

After the state's continuing economic boom from the 1940s through the 1980s, the early 1990s saw the start of a sudden, deep, and unexpected economic recession in California.[92] A series of natural disasters severely damaged California's economy: the drought of 1987-1992 cost California farmers $3-4 billion; the Loma Prieta earthquake of 1989 resulted in roughly $10 billion in losses, and property losses from the 1991 Oakland fire and the 1993 Southern California fires were estimated at $4.7 billion.[93] The Los Angeles riots of 1992, precipitated by the acquittal of four Los Angeles police officers who beat Rodney King, cost the state approximately $1 billion, and the 1994 Northridge earthquake further stressed the state's infrastructure.[94] California's economy had thrived for many years in part because of federal defense funding. However, the end of the Cold War brought with it a downsizing of federal money flowing into California's defense, high-tech, and aerospace industries and the closure of many military bases in California.[95] The state's economy was further weakened by increased immigration in the 1980s of poor people from Mexico and Central America moving to California.[96]

The state's downturn was compounded by a national recession which began in 1990. The California Commission on State Finance estimated that 50% of state job losses in the early 1990s were a result of the national recession, 25% had been lost due to the direct and indirect impact of national defense cutbacks, and 25% had been lost to various factors such as high state land costs, congestion, environmental concerns, and a difficult state regulatory environment for business.[97]

Indeed, a widely cited study of manufacturing firm migration out of California helped establish the image of a state losing jobs to other, more business-friendly states as a result of government-induced problems.[98] At the same time, a survey by the California Business Roundtable cited taxes, workers' compensation costs, and labour and housing costs as problems contributing to a worsening state business climate, and portrayed California policymakers as "indifferent if not hostile to business".[99]

California's government faced the most severe fiscal crisis of any state in the recession.[100] A series of state budget crises in the early 1990s repeatedly brought California to the brink of bankruptcy as the state's ability to raise taxes was constrained by several state initiatives, most notably the Proposition 13 initiative of 1978, which severely limited California's ability to collect revenue through property taxes. By 1992, the state, having run out of cash, was forced to issue IOU warrants, which were honored by many banks for only the first month. California's budget shortfall totaled $38 billion from fiscal years 1991/1992 to 1994/1995.[101] Moreover, California's governor and legislature seemed unable to effectively address the fiscal crisis, in part based on "the weakness of California's policy-making culture".[102] By June 1994, California's jobless rate of 8.3% was the highest of any industrial state, and domestic migration to the state turned negative.[103]

At the same time that California was suffering economically, the foreign investment the U.S. had grown increasingly dependent on to generate employment began to drop. In 1992, foreign direct investment in the U.S. fell 47% from the previous year in its fourth consecutive year of decline.[104] Observers felt that several factors lay behind this trend: 1) global recession; 2) increased economic integration in the European Union and the opening up of Eastern Europe diverting investment from the U.S.; and 3) an increase in trade and investment barriers in the U.S. after resentment to a foreign take-over wave in the 1980s created a backlash against foreign investment.[105]

Although the recession of the 1990s ran a full five years, California's economy has since rebounded.[106] By 1998, California had almost fully recovered from the recession, due largely to the diversity of its economy.[107] The state seems to have made a successful shift from an economy dependent on defense contracts to a more service-based economy, with the rise of Silicon Valley and the continued growth of the entertainment industry.[108] Even during the depths of the recession, the service sector never shrank, but only experienced slower growth for a few years.

4) Assets

a) Political

This section of the chapter will examine the factors Hocking defines as significant in determining the pattern of non-central government involvement in multilayered diplomacy: physical location within the federal system (core vs. periphery regions of political and economic power), general resources (which include political culture and membership in cooperative mechanisms such as the National Governors' Association), bureaucratic resources, the degree of asymmetry within federal systems, and the powers assigned to non-central governments within the federal system.[109] A further significant factor, the international linkages (geography, transborder relations, and cultural links) of non-central governments, will be discussed in the following section describing California's economic assets.

California is a core region of the U.S. political and economic landscape, yet its geographic distance from the East Coast policy establishment means it often experiences an asymmetry between its perceived power and its influence within the U.S. national arena, a feeling that it is 'not getting its due' from the central government. As a result, the state often views itself as a distinct region within the U.S. which needs the freedom to act independently of the federal government.[110] California has a long history of formulating environmental protection, worker safety, and consumer protection regulations more restrictive than U.S.

federal standards:[111] in many policy areas, California laws are often created before federal statutes exist.[112] There is a perception among state policymakers that a "California perspective" exists, and that such a perspective serves to raise both federal and international standards.[113]

At the same time, California holds important power at the national level. With the largest population of any U.S. state, California has the largest number of state electoral votes, 20% of the number needed to elect the president, and these votes are heavily courted in any presidential contest.[114] However, the state's influence on East Coast decision-makers peaks during presidential election years, and falls off somewhat afterwards.

The state fields two Senators and 52 Congresspeople, the largest state delegation in the U.S. Congress.[115] However, the state's diversity means its representatives often lack the shared sense of perspective that would result in a unified state agenda around which to unite. Instead, California's congressional delegation has traditionally divided sharply on partisan grounds, diluting its numerical strength.[116]

More evidence of California's political strength is provided from the fact that "California is widely viewed as a cradle of cutting-edge social and political movements".[117] Many of the recent political ideas which have sprung up in the United States started in California: the tax-revolt movement, the campaign finance reform movement, and debates over immigration, bilingual education, and affirmative action policies.[118]

Further, as detailed earlier, California has a strong political asset in its distinctive geography and ethnic composition. The state is geographically isolated from East Coast power centers, has links with Asia and Latin America instead of Europe, and contains a much more diverse ethnic base than the rest of the U.S. As a result, "California is in many ways not a state, but a nation".[119] Many California politicians, including former Governor Pete Wilson and ex-San Francisco Mayor Dianne Feinstein, have referred to the state as "the nation-state

of California".[120] This attitude helped strengthen California's willingness to confront foreign governments, multinational enterprises, and the U.S. federal government in the debate over its unitary tax method: in particular, federal threats of preemptive legislation created an "emotional forest fire".[121]

In addition, California possesses extremely strong bureaucratic resources. It has a large pool of highly-skilled government workers to draw on. As described at the beginning of this chapter, California's Franchise Tax Board runs a huge, efficient department with over 4,000 employees and an annual budget of over $200 million.[122] California has been at the forefront in developing state institutions, such as the World Trade Commission and the California Trade and Commerce Agency, to put forth a state international policy agenda. The California Assembly and Senate both house committees which promote the state's international trade and investment. California is also a member of many state group organisations: the Multistate Tax Compact, the Western Governors' Association, the Federation of Tax Administrators, the National Conference of State Legislatures, the Council of State Governments, and the National Governors' Association. Such groups give California the ability to effectively represent its interests within the U.S. federal system by joining its political assets with those of other states.

b) Economic

California possesses extremely strong economic resources which have propelled the state into becoming a "dominant player in national affairs".[123] In addition to having the largest state economy within the U.S., California has what is often calculated as the seventh largest economy in the world, with a gross state product of over $1 trillion.[124] California's economy is further strengthened by its structural diversity, which usually spares the state from regional economic downturns[125] (Chart 3 in Appendix 16 shows the varied composition of California's gross state product). California leads the nation in several sectors of the national economy: the computer, electronics, film and animation, multimedia, tourism, entertainment, biotechnology, semiconductor and aerospace industries.[126] California has oil,

natural gas, and timber reserves, and an extremely strong agricultural base, with important subsectors in citrus, livestock, cotton, timber, and specialty crops. This strong agricultural sector also accounts for the state's economic productivity in the food processing, fertilisers and pesticides, and farm machinery sectors.[127]

As the most populous U.S. state, California offers a major consumer market of 33 million people; the state accounted for roughly 12% of all retail sales in the U.S. in 1992.[128] In an age of increased international economic transactions, the state's culturally diverse labour and consumer markets have helped serve as a jumping-off point between California business and both Asian and Latin American markets.[129] California's cultural links to international markets have grown tremendously in recent years, fueled by a surge in immigration which started in the 1980s.[130] From 1982 to 1997, the state's population increased at a rate double the nation's population growth, with immigration coming mostly from Mexico and Central America, the Pacific Islands, and Southeast Asia. During the 1980s, "California's Latino population increased by 55% and its Asian population went up by 75%".[131] California's population is also highly educated, particularly in technical fields.[132]

California's large, ethnically diverse market and varied industry base position the state as a cultural leader, a trendsetter for both the U.S. and the world. California is an exporter of ideas, and the state's popular culture is emulated not only within the U.S. but throughout the world.[133] The California entertainment industry has proved the birthplace of many American trends, projecting an image of California worldwide. "Indeed, by the year 2001 it could almost be said that the popular image of the United States outside the borders of the United States was California-oriented. From this perspective, California had become the prism through which the world was viewing the United States itself".[134] In addition to entertainment, Silicon Valley's unique entrepreneurial business culture spawned a global set of imitators as California proved the predominant base for the 'new economy' of the 1990s.

However, California's economic assets, while extremely powerful, do fluctuate over time as its economy undergoes various phases. The state became increasingly dependent on foreign investment, particularly from Asia, during the mid-1980s (pgs. 143-144), and the economic recession of the early 1990s left the state in a much weaker position (pgs. 146-148).

5) California Unitary Reform Lobbying Groups

Several unitary reform lobbying groups specific to the state of California were formed in the 1980s, at the time of the first debate over the state's unitary tax method. At the same time, several California business groups already in existence became active lobbyists on the unitary issue. These groups and their policy agendas, detailed below, are summarised in Box 2 on p. 156.

The **California Business Council** (CBC), a group of approximately 90 U.S.-domiciled multinational enterprises (MNEs) headquartered in California, was formed in 1984 to demonstrate the collective strength of California companies opposed to the state's unitary tax method. The CBC lobbied to ensure that U.S. companies were included in any California unitary reform legislation, and sought to ban use of the WWC method entirely. The CBC was seen as the coordinating organisation for all domestic-domiciled companies opposed to the WWC method, and served as a focal point for fund-raising efforts on the issue in California.

With the CBC, domestic MNEs became much better organised and more visible in their opposition to any unitary reform which did not include domestic-domiciled companies, publishing a newsletter, The Unitary Update. The CBC was the first time Silicon Valley firms became involved in lobbying on a policy issue before the California legislature, since the high-tech industry was just emerging as an important force within California in the mid-1980s.[135] Silicon Valley firms were adamant that their foreign competition, notably Japanese firms, should not receive any advantage through a "foreign-only" solution to the problem.[136]

The **Organisation for the Fair Taxation of International Investment (OFTII)** was formed to represent foreign, mostly European, companies before the California legislature on the unitary issue. OFTII included European companies not comfortable being identified with British firms organised from London, or being viewed as foreign interests, as Japanese firms were.[137] OFTII attempted to demonstrate the integration of European companies in the California economy and work within California's local political system for unitary reform.[138] OFTII emphasised that a company's position on the unitary issue resulted from the organisation of its worldwide business, not its home nationality, and that unitary reform was not a 'foreign' issue since many U.S. MNEs were opposed to California's use of the WWC method.

The **Japan Business Association of Southern California (JBA)** had approximately 360 companies as members, and included nearly every major Japanese corporation with operations in the United States. The JBA lobbied to completely eliminate the WWC method for foreign-based corporations. They argued that from "the perspective of the current and potential California businesses that have direct ties to Japan, the unitary method of apportionment has had a significant negative impact on decisions to establish new operations as well as decisions relating to possible expansion of current operations".[139] In addition, they claimed the method was inequitable, placed an unduly onerous burden on foreign corporations, and forced businesses to leave California for U.S. states which did not employ the WWC method.[140]

The California Manufacturers' Association (CMA) is a group of both foreign and U.S.-domiciled companies operating in California which lobbies on general business issues before the California legislature. The CMA had a difficult time reaching a consensus on the unitary issue because its membership is very diverse.[141] In the end, the CMA lobbied for equity between foreign and domestic companies, opposed charging companies a fee to elect not to use the WWC method, and pushed for correct information from the Franchise Tax

Board on projected revenue losses from the elimination of the WWC method.[142] They argued unitary reform was needed for continued job growth in the state.

The **California Chamber of Commerce** had a membership of roughly 5,000 companies, both U.S. and foreign-domiciled, at the time of the unitary debate. The Chamber lobbies the California legislature on issues of broad importance to the business community, and seeks to promote international trade and economic development.[143] The California Chamber of Commerce sought to find a common position for its foreign and U.S. members on the unitary tax issue in order to avoid any split in the business community which would weaken unitary reform legislation, which they felt was necessary to promote California's economy.[144] As a result, it advocated a position acceptable to all, that companies should have the right to elect whether to be taxed under the WWC method. The California Chamber of Commerce coordinated its efforts at the national level with the Committee on State Taxation, the National Foreign Trade Council, and the Tax Executives Institute.

The **California Unitary Tax Campaign (CUTC)**, a small group of U.S.-domiciled companies based in California, was concerned with regulations the Franchise Tax Board proposed in 1986 which would have more strictly defined which companies were considered functionally integrated, and therefore eligible to file as unitary companies. The proposed change in regulations had been driven by the Committee on State Taxation, which argued a more definitive standard of what constituted a unitary business would make its use less subjective. The approximately 25 U.S.-domiciled MNEs that joined CUTC were all diversified U.S. businesses which had lower tax bills when filing under the WWC method, and resisted FTB reforms that would effectively exclude their companies from using the method. As a result of their efforts, the FTB withdrew the proposed regulations, and continued to use the more subjective 'strong central management' definition of unitary companies.

The **California Tax Reform Association** lobbied against California's unitary reform legislation in 1993 on the grounds that the legislation provided a tax break for big business at the expense of state social service and health care needs during an economic recession. The California Tax Reform Association was the only state-level group formed specifically to lobby against unitary reform, and led a coalition of local groups which opposed eliminating the WWC method: the California Council of Churches, the California Federation of Teachers, the State Building and Construction Trades Council of California (an affiliate of the AFL-CIO), the Education Coalition of California, the California Faculty Association, the Lutheran Office of Public Policy – California, the California Teachers' Association, and the California Taxpayers' Association.

At the same time, state and local economic development agencies and chambers of commerce lobbied against state use of the WWC method on the grounds that it hurt their efforts to attract MNE investment. For example, the San Diego Economic Development Corporation was active in trying to repeal California's WWC method after meetings with Japanese executives convinced them the method cost California jobs.

Box 2: California Unitary Reform Lobbying Groups

Lobbying group	Agenda	
California Business Council (CBC)	Ban WWU method	Coordinate domestic companies
	Include U.S. companies in any reform legislation	Serve as a focal point for fund-raising among domestic companies
Organisation for the Fair Treatment of International Investment (OFTII)	Represent non-British European companies in California	Rise above questions of nationality
	Demonstrate integration of European companies in the California economy	
Japan Business Association of Southern California (JBA)	Ban WWU method for foreign-domiciled companies	Represent Japanese company interests
California Manufacturers' Association (CMA)	Represent both foreign and domestic business in California	Promote equity between domestic and foreign businesses in California
	Oppose election fee	
	Push for correct revenue loss estimates from FTB	
California Chamber of Commerce	Represent both foreign and domestic business in California	Promote issues of broad importance to the California business community
	Promote international trade and economic development	Support companies' right to elect whether to be taxed under the WWC method
California Unitary Tax Campaign	Resist Franchise Tax Board's tighter definition of which companies were functionally integrated and therefore eligible to file as unitary companies	
California Tax Reform Assoc.	Stop California unitary reform legislation as a tax break for big business	Argue the needs of state social services during an economic recession

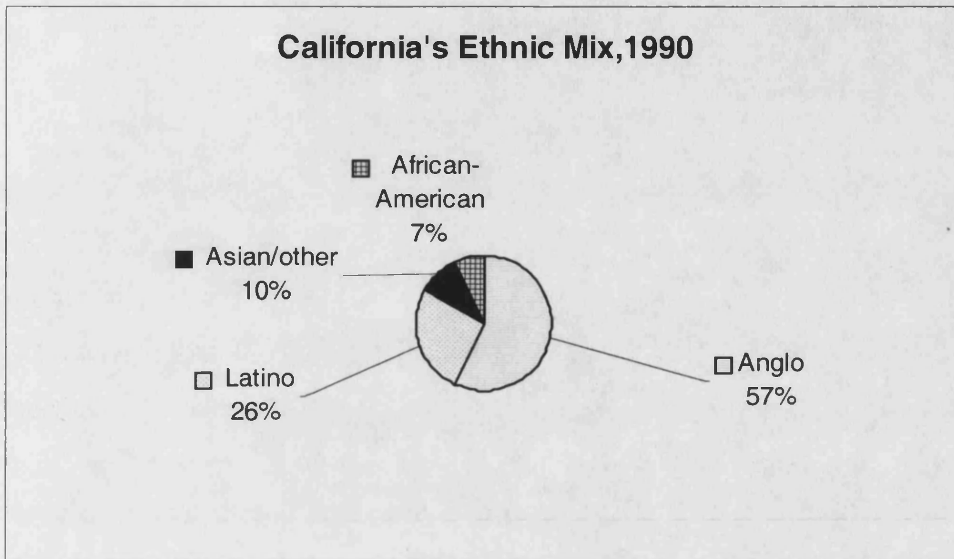
6) Summary

This thesis examines newly evolving modes of state-firm bargaining over subfederal economic policies, policies which have increased international repercussions with the growth of foreign trade and investment within U.S. state jurisdictions. It has described California's political economy in order to gain a better understanding of both the subfederal setting for the unitary tax debate and the state's resources as a key actor during the debate. The chapter has analysed the political and economic structure of the state and its political and economic assets, considering such factors as physical location within the federal system, international linkages, political culture, bureaucratic resources, and the degree of asymmetry within the federal system.[145] California has a large, rich and distinct economy and a political culture with a history of policymaking independence from the federal government. The state is an active participant in the international economy and has created various institutions to implement its international objectives, including the development of a state trade policy agenda.

As we shall see in the following chapter, these strong state assets, along with the legal ambiguity of U.S. federalism described in Chapter Three, gave California the ability to bargain directly as an actor in the international arena during the debate over its unitary tax method. California's high level of international economic activity meant the state's regulatory policies affected many foreign MNEs doing business within California. However, California's assets within the U.S. federalist system led the national government to refuse to effectively constrain the state's regulatory deviance. At the same time, California's assets strengthened the state's ability to bargain directly and effectively with the foreign governments and MNEs which protested its use of the WWC unitary tax method. This chapter has therefore lent support to the hypotheses put forth in Chapter One that powerful U.S. states such as California have the ability to both maintain regulatory standards at odds with federal and international norms and to bargain directly within the international arena to defend those economic regulations.

The following chapter will present a case study of the debate over California's use of the worldwide combined unitary tax method, a subfederal economic regulation at odds with federal and international norms. California's use of the WWC method conflicted with both U.S. national policy and international tax agreements, yet the state refused to change its method despite heavy lobbying by the U.S. federal government, foreign governments, international organisations, and MNEs. During the time of the unitary debate, the California economy both grew more dependent on the world economy and went into recession. Chapter Five will detail the bargaining which took place over California's use of the WWC method and which ultimately led the state to change its unitary tax policy.

Figure 6



Source: California Department of Finance Demographic Research Unit, Report 93, April 1993. p. 3.

Figure 7

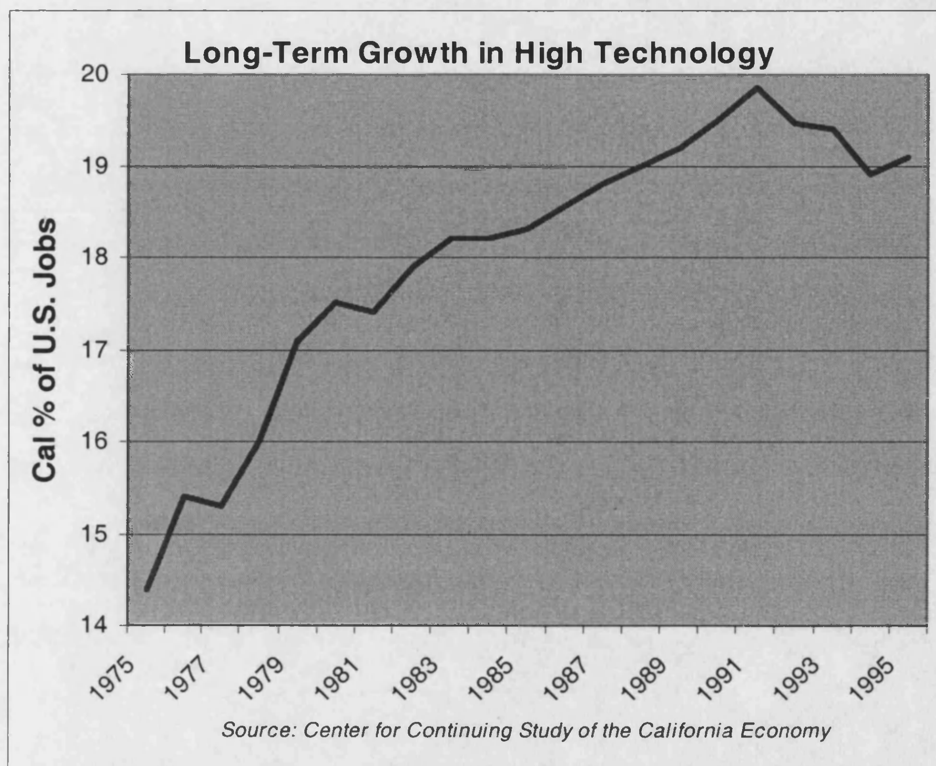


Figure 8

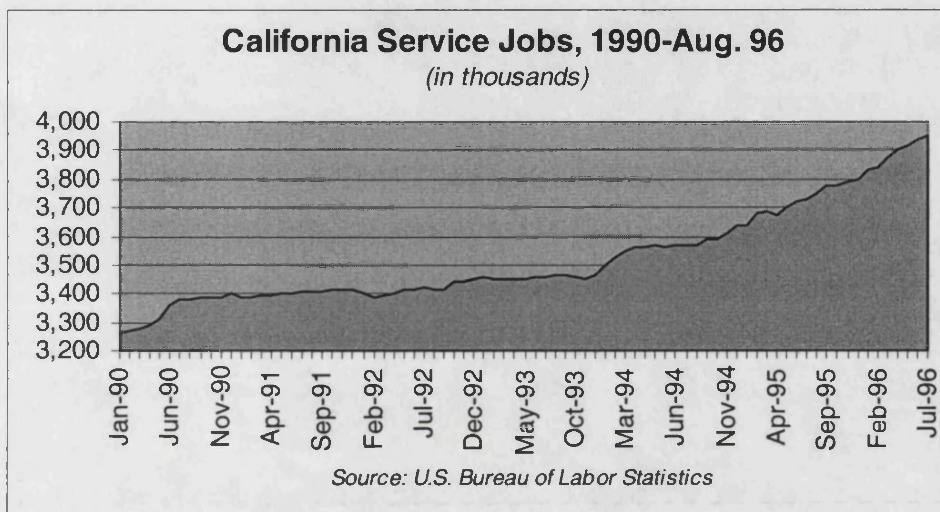


Figure 9

Figure 10

Figure 11

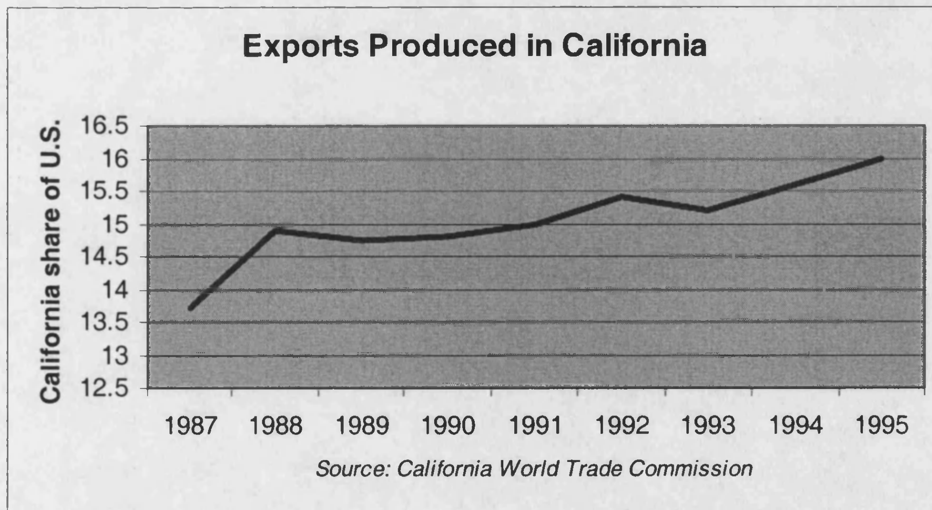


Figure 12

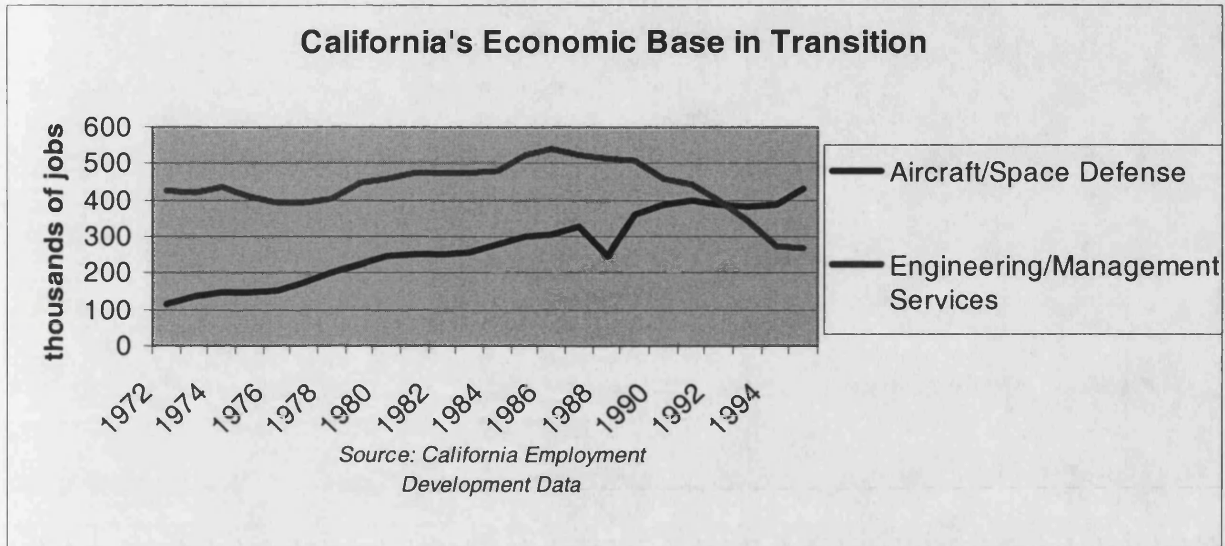


Figure 13

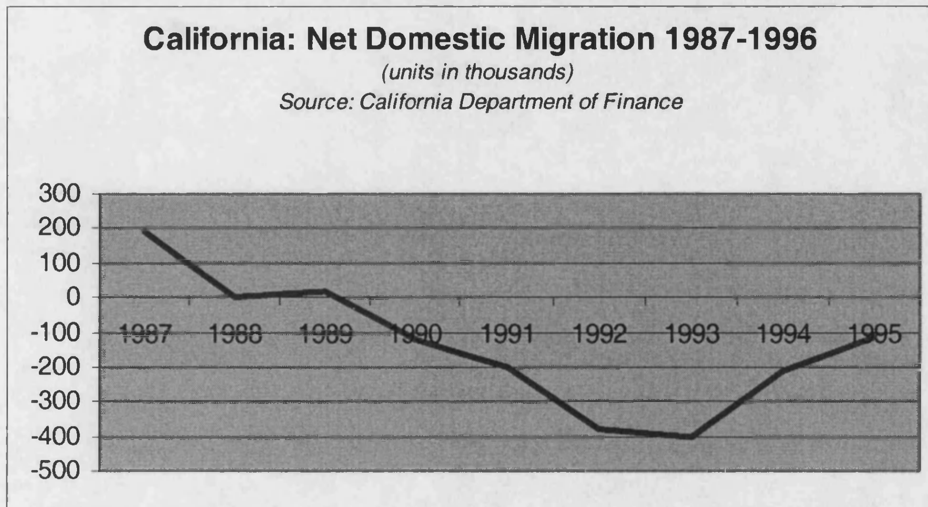
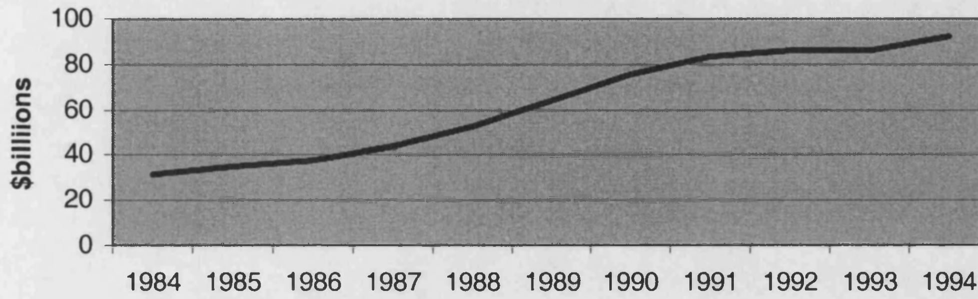


Figure 14

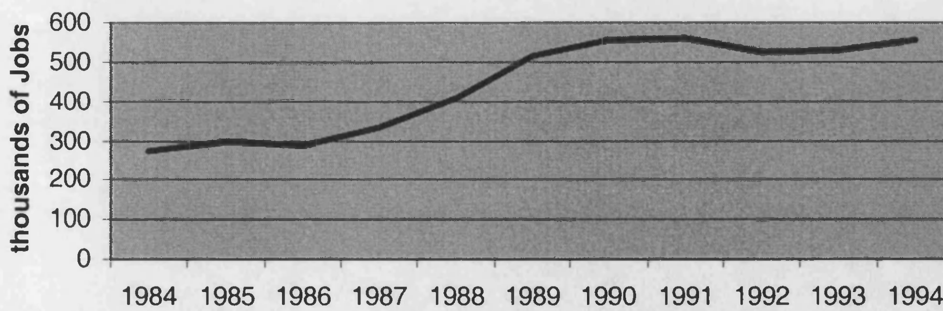
Growth of Foreign Investment in California, Book Value 1984-1994



Source: California Trade & Commerce Agency, Office of Foreign Investment "Foreign Direct Investment in California", February 1997, p. 2.

Figure 15

Growth of Foreign Investment in California, Employment 1984-1994



Source: California Trade & Commerce Agency, Office of Foreign Investment. "Foreign Direct Investment in California", February 1997, p. 2.

Figure 16

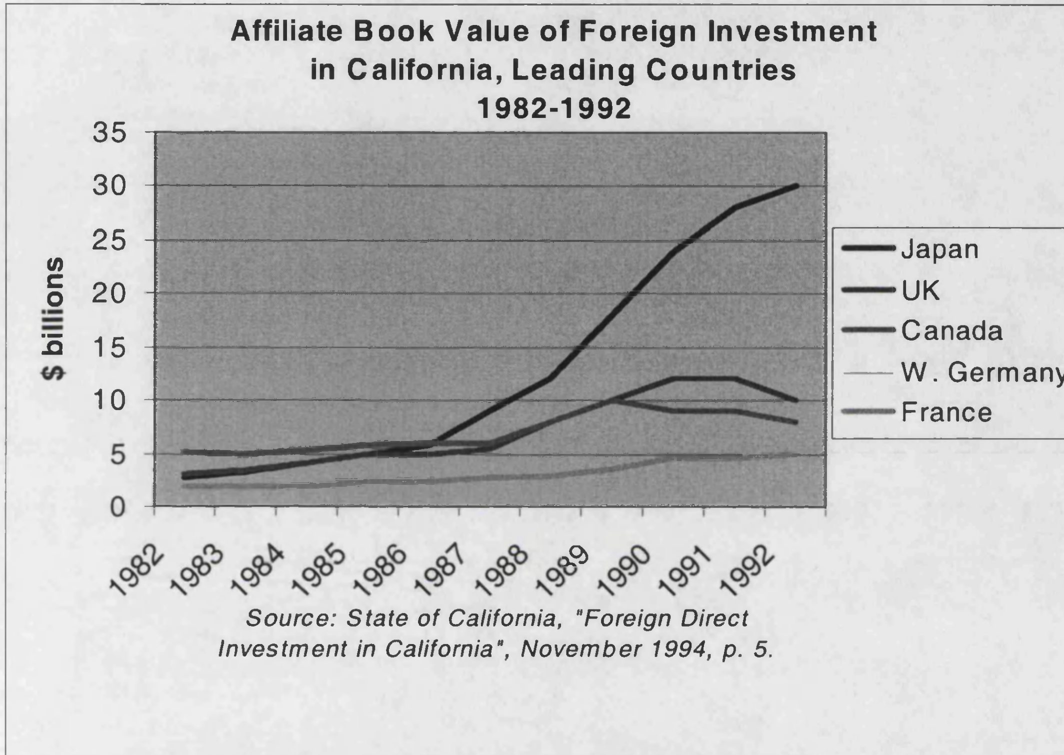


Figure 17

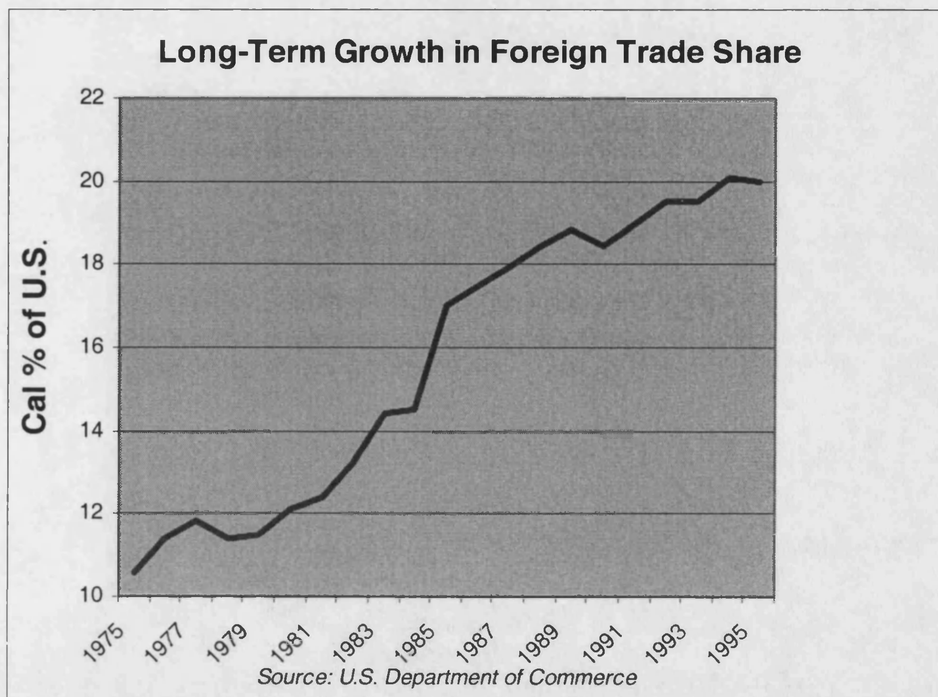


Chart 1: 1998 Gross Product Ranking

		($ billions)
1	United States	7,902.9
2	Japan	4,089.1
3	Germany	2,179.8
4	France	1,465.4
5	United Kingdom	1,264.3
6	Italy	1,157.0
	California	**1,118.9**
7	China**	1,081.8
8	Brazil	767.6
9	Canada	580.9
10	Spain	555.2

*** Includes Hong Kong, which was transferred to China on July 1, 1997.*
(China $923.6 billion; Hong Kong $158.2 billion)

Estimates are from the 2000 World Bank Atlas, except for California, which is from the December 2000 UCLA Anderson Forecast.

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[1] Hocking, 1992.
[2] Hocking, 1999, p. 25.
[3] Ooley, 2003.
[4] Gerston and Christensen, 1999, p. 45.
[5] California Journal, 1995, p. 9.
[6] Gerston and Christensen, 1999, p. 77.
[7] Ibid.
[8] Gerston and Christensen, 1999, p. 80.
[9] Cahn, Schockman, and Shafie, 2001, p. 103.
[10] Ibid., p. 103 and p. 41.
[11] Ibid., p. 42.
[12] Ibid., p. 52.
[13] Ibid., p. 81.
[14] Gerston and Christensen, 1999, p. 71.
[15] California Journal, 195, p. 11.
[16] Cahn, Schockman, Shafie, 2001, p. 106.
[17] Ibid.
[18] Ibid.

[19] Ross, 2000, p. 107.
[20] League of Women Voters, 1992, p. 98.
[21] Interview #32.
[22] California Franchise Tax Board, November 1993.
[23] For tax years 1988 through 1994.
[24] California Franchise Tax Board, November 1993.
[25] Interview #33.
[26] Interview #38.
[27] League of Women Voters, 1992, p. 46.
[28] Interview #38.
[29] California Journal, 1995, p. 19.
[30] Joint Committee on the State's Economy and the Senate Select Committee on the Pacific Rim, 1986, p. 42-43.
[31] Interview #41.
[32] California Trade and Commerce Agency, 1997, p. 3.
[33] State of California, 1994, p. 19.
[34] Interview #27.
[35] Capitol Enquiry Inc., 1997.
[36] Interview #27.
[37] State of California, 1994, p. 19.
[38] Interview #27.
[39] Ibid.
[40] Fry, 1998, p. 72.
[41] Ross, 2000, p. 367.
[42] Ibid., p. 59.
[43] Ibid.
[44] Cahn, Schockman, and Shafie, 2001, p. 25.
[45] Ross, 2000, p. 59.
[46] Cahn, Schockman, and Shafie, 2001, p. 2.
[47] Ibid., p. 4-5.
[48] Gerston and Christensen, 1999, p. 11.
[49] Ibid.
[50] Korey, 1999, p. 29.
[51] Ross, 2000, p. 60.
[52] Ibid., p. 62-63.
[53] Ibid., p. 61.
[54] Ibid., p. 62.
[55] Ibid., p. 64.
[56] Ibid., p. 83.
[57] Korey, 1999, p. 44.
[58] Ross, 2000, p. 107.
[59] Ibid.

[60] Interview #3.
[61] California Technology, Trade and Commerce Agency, 2003, Citation 1.
[62] California Technology, Trade and Commerce Agency, 2003, Citation 2.
[63] Gerston and Christensen, 1999, p. 7.
[64] California Technology, Trade and Commerce Agency, 2003, Citation 3.
[65] California Technology, Trade and Commerce Agency, 2003, Citation 4.
[66] See Charts 6 and 7 in Appendix 16, which demonstrate the large percentage of Californians with a college education and the predominance of top-rated graduate schools in science in the state.
[67] See Figure 7 at the end of this chapter and Figure 3 in Appendix 16, which both demonstrate the growth of high-tech industries in California.
[68] Dardia and Luck, 1999, p. 9.
[69] Korey, 1999, p. 1.
[70] Starr, 2003. "California: The Dream, the Challenge".
[71] California Technology, Trade and Commerce Agency, 2003, Citation 1.
[72] Korey, 1999, p. 1.
[73] Lyon, 1998, p. 1.
[74] Ibid., p. 4.
[75] California World Trade Commission, 1993.
[76] Ibid., p. 4. See Chart 4 in Appendix 16 and Figure 11 at the end of this chapter for U.S. state foreign export totals and California's share of total U.S. exports.
[77] Ibid., p. 6. See Figures 14, 15, and 16 and Charts 9 and 10 in Appendix 16 to see the growth of foreign investment in California, which countries led this investment, and the amount of foreign investment attracted to California vs. the rest of the world.
[78] Bureau of Economic Analysis, U.S. Department of Commerce.
[79] Office of Foreign Investment, 1997, p. 3. Figure 1 in Appendix 16 compares the breakdown of foreign investment by sector in California vs. the rest of the U.S.
[80] Office of Trade and Investment, 1997.
[81] Goldsborough, 1993, p. 89.
[82] Figure 6, at the end of this chapter, shows California's ethnic composition in 1990.
[83] Starr, 2003.
[84] Carson, 1987, p. A-3.
[85] Joint Committee on the State's Economy and the Senate Select Committee on the Pacific Rim, 1986, p. 138-141.
[86] Ibid., p. 147.
[87] Ibid., p. 29.
[88] Ibid., p. 50.
[89] Ibid., p. 53.
[90] Ibid., p. 51.
[91] Goldsborough, 1993, p. 89.
[92] Lyon, 1998, p. 1.
[93] Chapman, 1995, p. 105.

[94] Cahn, Schockman, and Shafie, 2001, p. 55.
[95] Defense outlays in California peaked in 1988 at $63 billion (in 1993 dollars); these outlays were estimated to fall to $33 billion in 1997 under the 1993 Clinton administration proposal (Chapman, 1995, p. 106). During the 1988 and 1991 rounds of base closings, eighteen California military bases were closed. Twelve additional California bases were listed in the 1993 round of closings. It was estimated that 162,000 defense-related jobs were lost in California between January 1988 and January 1993, while an additional 125,000 jobs were projected to disappear by the end of 1997. Chapman, 1995, p. 106. Also see Figure 12 at the end of this chapter and Figure 2 in Appendix 16, which show the decline in defense industries as a share of California manufacturing jobs.
[96] The 1986 U.S. National Immigration Control and Reform Act granted amnesty to some specific groups of undocumented immigrants and established the State Legalization Impact Assistance Grant (SLIAG) program to provide $3.5 billion to reimburse state and local services for a variety of basic health, welfare, and education services for three million newly legalised citizens. However, the U.S. national government provided less than the full SLIAG financial support promised, leaving California with a large fiscal deficit. California housed more of the newly legalised residents than all of the other states combined: an estimated 54 percent. Chapman, 1995, p. 106.
[97] Chapman, 1995, p. 107.
[98] Report is *California Industry Migration Survey*, Bules & Associates, San Francisco, California, October 1992. Dardia and Luck, 1999, p. 6.
[99] Dardia and Luck, 1999, p. 8.
[100] Ibid.
[101] Cahn, Schockman, and Shafie, 2001, p. 55.
[102] Gold, 1995, p. 367-368.
[103] Altman, 1994. Figures 10 and 13, at the end of this chapter, show California's rising unemployment rate and falling net domestic migration during this period. Figure 4 in Appendix 16 shows the drop in California's employment levels over the same period.
[104] Dickson, 1993.
[105] Ibid.
[106] Lyon, 1998, p. 1.
[107] Gerston and Christensen, 1999, p. 10.
[108] Dardia and Luck, 1999, p. 25.
[109] Hocking, 1999, p. 25.
[110] Goldsborough, 1993, p. 88.
[111] Interview #28.
[112] Interview #36.
[113] Interview #42, Interview #31.
[114] Ross, 2000, p. 54.
[115] Capitol Enquiry Inc., 1997, p. 89-90.
[116] Ibid.
[117] Cahn, Schockman, and Shafie, 2001, p. 11.

[118] Ross, 2000, p. 114, p. 132.
[119] Goldsborough, 1993, p. 88.
[120] Feinstein, 1987, p. 5.
[121] Interview #25.
[122] California Franchise Tax Board, November 1993.
[123] Cahn, Schockman, and Shafie, 2001, p. 49.
[124] Chart 1 at the end of this chapter.
[125] Gerston and Christensen, 1999, p. 10.
[126] Cahn, Schockman, and Shafie, 2001, p. 51.
[127] DeBow and Syer, 1997, p. 8.
[128] California World Trade Commission, 1993, p. 3. Charts 11 and 12 in Appendix 16 show the median income of households by U.S. state and total personal income in California. Chart 13 in Appendix 16 compares gross U.S. state products over time. Further, Appendix 5 compares U.S. gross state products with national gross products by size.
[129] DeBow and Syer, 1997, p. 64.
[130] Ibid., p. 5.
[131] Ibid., p. 5 and 6.
[132] See p. 141.
[133] Cahn, Schockman, and Shafie, 2001, p. 11.
[134] Starr, 2003.
[135] Interview #42.
[136] Interview #35.
[137] Interview #25.
[138] Ibid.
[139] Ota, 1980.
[140] Ibid.
[141] Interview #36.
[142] Interview #36.
[143] Interview #31.
[144] Ibid.
[145] Hocking, 1999, p. 25.

Chapter 5: The Case Study

1) Introduction

The previous chapters have demonstrated that powerful U.S. states such as California possess the capability to maintain regulatory standards at odds with federal and international norms and to bargain directly in the international arena. This chapter will provide further evidence towards these hypotheses as it presents a factual case study of the debate over California's use of the worldwide combined unitary tax method. Chapter Three provided an overview of the actors who took part in the debate over California's tax method, describing each actor's role in influencing U.S. state tax policy, its agenda with regards to state use of the worldwide combined (WWC) unitary tax method, and the political and economic assets that it had at its disposal. Chapter Five will now provide a detailed look at the extent and direction of each actor's involvement in the debate over California's use of the WWC tax method. The following chapter will complete the model of state-firm bargaining over subfederal economic policies which conflict with federal and international norms by analysing this case study to determine how effectively the actors used their assets to influence the outcomes of the policy debate.

This chapter will start with a brief background on the use of the worldwide combined unitary tax method in California. It will then detail the first major international debate over U.S. state use of the method, the negotiations surrounding the 1979 U.S.-UK tax treaty. This will be followed by a look at different foreign government reactions to U.S. state use of the WWC method and the Reagan administration's response to these protests. A brief survey of California's initial legislative attempts to reform its unitary method is followed by a detailed examination of the federal Worldwide Unitary Working Group formed in 1984. The chapter will then describe foreign government threats of retaliation and U.S. federal government threats of preemptive legislation. The case study will next examine court cases which ruled on the method's legality, as well as increased

corporate lobbying at the state level. It will then describe the negotiations surrounding California's 1986 unitary reform law, and reactions to this law.

Next, Chapter Five will examine legal attempts after 1986 to further modify California's unitary tax method, focusing on the progression of the Barclays Bank and Colgate-Palmolive cases against the California Franchise Tax Board to the U.S. Supreme Court. It will examine the impact of the Bush and Clinton presidential administrations, along with accelerated threats of UK retaliation, on these legal cases. Finally, this chapter will present an examination of California's second attempt at unitary tax reform in 1993 in the face of these various pressures. Box 3, on p. 186, lists the milestones in the California unitary tax debate.

At the beginning of this thesis, the question was asked: what happens when U.S. state economic regulations conflict with international norms? The following case study will add to the body of academic literature on subfederal activity in the international arena. Stopford and Strange view negotiations over economic policies as existing within a complex and dynamic framework of state-firm bargaining. However, they state that "we shall make little progress on the vaster issues until we have collected and analysed much more data on the relations of firms to governments and governments to firms. We shall certainly not be able to make more sense of general theories of bargaining power between states and firms".[1] This chapter aims to collect relevant data on the relationships between national governments, subfederal governments, and MNEs during the debate over California's unitary tax method. The following chapter will analyse this data: both hope, on their own terms, to contribute to the application of state-firm bargaining theory to the subfederal level.

2) Case study

i) History of the worldwide unitary tax method in the U.S.

California's franchise tax was enacted in 1929 to tax all corporations which derive income from sources within California. In order to help implement the franchise tax, the

California corporate income tax was enacted in 1937 to tax income from intra-state commerce. The theory of unitary apportionment was first given statutory authority in California in 1939, when the unitary tax method became part of the state's Bank and Corporation Tax. The statute was worded so that the unitary combination method included foreign activities overseas as well as domestic; however, the tax code did not specify whether foreign-based companies were required to file on a worldwide unitary basis.[2] In *Butler Bros* v. *McColgan*[3] (1941), the California Supreme Court determined a test of "three unities" to establish whether a business could be considered unitary: unity of ownership; unity of operations, as evidenced by central merchandising, advertising, accounting, and management decisions; and unity of use, demonstrated by centralised executive control and general systems of operations.[4] By the early 1960s, California's Franchise Tax Board (FTB) had begun to apply unitary combination to the foreign activities of U.S.-based multinational enterprises (MNEs) on a widespread basis. The number of MNEs in California had risen enough by the 1960s to make overseas activities a bigger proportion of the state's tax base, and its accurate measurement had assumed greater significance.

In 1964 and 1965, the U.S. House of Representative's Committee on the Judiciary held a Special Subcommittee on State Taxation of Interstate Commerce, popularly known as the Willis Committee, after its chairman. The Willis Committee severely criticised the lack of uniformity among states in apportioning income for taxation, and issued a report which called for states to tax the foreign income of companies incorporated in the U.S. only if their income was already subject to tax by the U.S. federal government.[5] This requirement would have effectively required a replacement of the worldwide combination (WWC) method incorporated in California's statute with the water's edge combination method, excluding the resources of all overseas affiliates from the state's taxable base.

In a successful attempt to forestall federal legislation introduced by Willis on October 22, 1965 as House of Representatives (HR) 11798, the states held a National Conference of Commissioners for Uniform State Laws, which drafted a proposed state code, the Uniform Division of Income for the Purposes of Tax Assessment (UDIPTA).

UDIPTA was unanimously enacted into law in California in 1966. Subsequent hearings were held in the House of Representatives on HR11798, but the bill was never acted on.

By 1967, California's Franchise Tax Board had adopted the position that the unitary combination method was to be applied on a mandatory basis to all MNEs, both foreign and domestic-domiciled, with foreign activities. This advance in the use of the unitary method was not a statutory change in California's law, but simply a new administrative interpretation by FTB staff as to how California state audits were to be conducted. Both U.S. and foreign MNEs increasingly began to complain, in both the California legislature and in the U.S. Congress, that the FTB was being unduly aggressive and taking the pretense that the WWC method had to be employed since corporations were deliberately trying to shift their taxable income out of the state. MNEs also complained that the FTB definition of a unitary business was arbitrary, determined mostly by a desire to collect more tax revenue for the state. In 1969, the Committee on State Taxation (COST), a group of mostly U.S.-domiciled MNEs associated with the Council of State Chambers of Commerce, was formed specifically to lobby against California's application of the WWC unitary method.

At this point, a split developed between California companies with international links who opposed the WWC unitary method, and companies with purely domestic activities worried that unless the WWC method was used to force international business to shoulder a fair share of the tax burden, the state would implement higher overall tax levels, which would typically have a greater impact on purely in-state business. This division deepened as the number of MNEs in California grew.

In 1975, a Task Force on Foreign Source Income was held under the U.S. House Committee on Ways and Means. Its report, released on March 8, 1977, had no significant disagreement with the states' use of formulary apportionment over separate accounting methods, stating that the arm's length standard produced significant problems at the federal level and was difficult to administer at the state level. However, the Ford and Carter administrations both opposed California's extension of WWC to include the

overseas income of foreign-domiciled corporations on the grounds that this tax method interfered with U.S. bilateral tax treaties based on the arm's length standard. In 1977, the U.S. House of Representatives formed a second Task Force on Foreign Source Income. In line with the Willis Commission's recommendations, the Task Force report recommended that states not be allowed to subject the income of foreign affiliates to state tax unless their income was subject to federal income tax. In the 96th Congress of 1979, these Task Force proposals were incorporated into a State Foreign Source Income Tax Bill.[6] Despite the Carter administration's support, no vote was ever taken on this bill.

ii) The 1979 U.S./UK Tax Treaty

The UK-U.S. tax treaty, initialed on December 31, 1975, contained a provision under Article 9 (paragraph 4) which would have prevented U.S. states from applying the unitary business method to the income of British multinationals.[7] Several states which stood to lose a substantial amount of revenue from this provision argued that federal limitations on their powers to tax should only come through legislation which had been debated in Congress, not through treaty negotiations which involved only the executive branch.

In response to state lobbying efforts, Senator Church from Idaho put forth a reservation to the treaty which nullified Article 9(4). The 1975 treaty finally came up for a full U.S. Senate vote on June 23, 1978, but it did not obtain the majority vote it needed to pass until the Church reservation was inserted, removing the unitary tax exemption for British MNEs. The final treaty, which entered into force on April 25, 1980, specifically exempted U.S. state and local governments from any treaty prohibitions on worldwide unitary taxation.

The initial inclusion in the UK-U.S. tax treaty of the provision exempting British MNEs from state WWC unitary taxation seems to have been in concession for the British providing U.S. companies with partial refunds of the advance corporation tax (ACT) payment their British subsidiaries paid to UK Inland Revenue. Under UK law, only British shareholders could technically claim a refundable tax credit to offset the ACT;

U.S. shareholders needed the treaty exemption to do so. Although the final treaty did not exempt British MNEs from U.S. state use of the WWC method, it still allowed U.S. companies to claim a British tax credit offsetting the ACT. It appears the British parliament approved the tax treaty containing the British concession under the understanding that Congress intended to instead pass legislation prohibiting U.S. states from using the WWC method.

The U.S. federal government continued to attempt to persuade the states that its use of the WWC method interfered with U.S. treaty obligations, since U.S. bilateral tax treaties enshrined the arm's length standard. However, no vote was taken on several pieces of legislation introduced in Congress early in President Reagan's term which would have limited state unitary taxation to the 'water's edge' of business activities within the U.S., as there was little desire in Congress to take on the politically unpopular issue of federal preemption of state taxation powers.[8]

The UK government continuously pushed for U.S. Congressional legislation restricting the unitary method. The UK government at the time, firmly in Conservative hands, was a strong proponent of business interests. More generally, the UK economy has as a key component a large amount of foreign investment abroad by British MNEs, and the UK government is generally extremely supportive of international norms which support the free flow of foreign investment.

By 1982, the chairman of the British Conservative Party's Industry Committee had threatened a retaliatory British unitary tax on U.S. companies unless the U.S. federal government passed legislation restricting the states. This threatened action was estimated to potentially cost U.S. companies up to $674 million a year.[9] On July 12, 1983, the UK Chancellor of the Exchequer sent a letter protesting the states' use of WWC unitary taxation to the U.S. Secretary of the Treasury, Donald Regan. Prime Minister Thatcher also tried to persuade President Reagan to outlaw the method, but, in one of the few incidents where their personal relationship failed, Reagan rebuffed her at the 1983 Williamsburg Group of Seven summit meeting.

iii) Other foreign protests

a) Japan

Japanese MNEs were the most prominent early protesters against U.S. state use of the WWC method. In October 1981, the Japan-U.S. Economic Relations Group urged U.S. Congressmen to examine the detrimental effect of state use of the WWC method on U.S.-Japanese relations. On December 8, 1981, the Keidanren issued a "Resolution Urging Abolition of the Unitary Tax Formula Based on Worldwide Income by State Authorities of the United States of America". In July 1983, "Agenda for Action", a Joint Task Force Report by the U.S.-Japan Businessmen's Conference, recommended that state WWC unitary tax methods be abolished by either state or federal laws.

The Keidanren Investment Expansion Mission visited 23 U.S. states during 1984 to protest against state use of the WWC method and receive reassurances from non-WWC states that they would not change their tax systems. The Keidanren warned that Japanese companies would channel their investments only to states which did not use the WWC tax method. The Japanese received pledges from the following states not to enact a WWC method: Alabama, Hawaii, Kansas, Mississippi, New York, North Carolina, and Virginia. In April 1984, the Electronic Industries Association of Japan urged support for bills before the U.S. Congress which would abolish state use of the WWC method, stating that unless Congress actively opposed the states' unitary tax methods, U.S.-Japan trade and investment relations would worsen.[10] The Japanese government's close ties to business and heavy dependence on foreign investment for economic growth led to the government's support for Japanese MNEs protests that the unitary tax method was a potential inhibitor of investment in an important overseas market (see Figure 16, p. 164, Chapter 4).

b) Canada

Canada made numerous diplomatic protests to the U.S. federal government over state use of the WWC method: the attachment of a note to its tax treaty with the U.S.,[11] and letters from its charge d'affaires to the U.S. Assistant Secretary of the Treasury[12] and the U.S. Assistant Secretary of State for Economic and Business Affairs[13] asking for their

support for a 1983 U.S. Senate bill which proposed limiting unitary taxation by U.S. states to the 'water's edge' of business activities within the U.S.[14]

c) Germany

On November 28, 1983, the German Embassy issued a Memorandum to the U.S. Treasury Department condemning the states' use of worldwide combination and formula apportionment methods. This document warned that "failure to bring this development to a halt and to eliminate the international incidence of unitary taxation might lead the international community to conclude that the United States has ceased to speak with one voice and thus is no longer contributing to the international tax order toward which the United States, the Federal Republic of Germany and other nations have worked for so many years".[15]

d) The Netherlands

Starting in 1973, consultations between the Dutch Ministry of Finance and Dutch industry were held to investigate the possibility of eliminating U.S. state use of the WWC method. These consultations were suspended when the UK government began negotiating with the U.S. for similar protection, as the Dutch decided to wait and request similar protection once it had been granted to the UK. However, after the U.S. Senate did not approve the exemption of British companies from state WWC methods in the 1979 U.S./UK Tax Treaty, the Dutch government renewed the issue.

On March 26, 1980, representatives of the Council of the Netherlands Federation of Employers testified before the California Senate Committee on Revenue and Taxation in support of California Assembly Bill (AB)525, which proposed limiting the state's use of worldwide combination. Their testimony claimed that the 1956 Dutch Treaty of Friendship, Commerce and Navigation with the U.S. prohibited state use of the WWC method, since Article XI, paragraph 4 of the treaty stated that both parties "shall not impose or apply any tax, fee or charge upon any income, capital or other basis in excess of that reasonably allocable or apportionable to its territories".[16] The Netherlands State

Secretary for Finance also stated that the unitary method amounted to extra-territorial taxation, violating international law.[17]

The Netherlands government repeatedly declared that continued U.S. state application of the WWC method was a serious obstacle to a successful revision of the existing Netherlands-U.S. double taxation convention. The Dutch Finance Ministry stated it was hopeful that once the U.S. states accepted a water's edge limitation to their unitary methods, prohibition against applying the WWC method to foreign companies could be included in formal treaty arrangements with the U.S.[18] In 1985, the Dutch refused to ratify a trade agreement with the U.S. in protest over the states' continued use of the WWC method.

e) The European Community

In 1979, a statement from all nine European Community (EC) countries opposing subfederal use of the WWC method was submitted to the House Task Force on Foreign Source Income, with a copy sent to Governor Brown of California. The EC sent numerous such notes to the U.S. federal government protesting the international application of the unitary tax method by U.S. states.[19] In addition, the unitary taxation issue was discussed during a December 1983 meeting between Commission members and U.S. cabinet ministers.[20]

iv) The Reagan administration

The Reagan presidential administration opposed U.S. state use of the worldwide unitary tax method, although Reagan himself had supported California's use of the method when he was governor of California. The Reagan administration was also somewhat split over the issue. The Treasury Department had historically been one of the main proponents of the arm's length standard at the international level, and was opposed to having an inconsistent method in use at the state level; the U.S. State Department clearly wanted to accommodate protesting foreign governments. In addition, the Republican administration generally wanted to support pro-business legislation.[21] However, there was a very strong push for federalism in the early Reagan administration

through the Office of Intergovernmental Relations, a powerful group which represented the states' view to the White House that the WWC method provided an important tax base which should not be preempted by a federal ban.[22] The Reagan administration was lobbied heavily by the National Governors' Association not to file briefs against state interests in court cases involving state use of the WWC method.[23] In addition, the administration did not want to deny states a means of increasing their tax revenue at a time when it was asking the states to assume more fiscal responsibilities as President Reagan pursued his program of "fiscal federalism".

A September 30, 1981 report by the General Accounting Office (GAO) was highly critical of the Internal Revenue Service's enforcement of the arm's length standard under Section 482 of the U.S. Internal Revenue Code.[24] The GAO recommended that the Treasury Department study additional ways to allocate income under Section 482, including the use of formulary apportionment methods, in order to alleviate MNE income-shifting to take advantage of disparate corporate tax rates between countries. The Treasury Department disagreed with this recommendation, and remained opposed to the use of formulary apportionment.

However, the General Accounting Office issued another report in July 1982, "Key Issues Affecting State Taxation of Multijurisdictional Corporate Income Need Resolving",[25] which stated that unitary methods were difficult to use since it was not easy to determine what should be included in a unitary business or how it should be defined, and that court decisions in this area had been vague, offering no further definition.[26] The report was also fairly critical of nonconformities between state tax rules, stating these could lead to over or under-taxation of MNEs.

v) Early California attempts at legislation

In 1979, the California Assembly Revenue and Tax Committee held a hearing in Los Angeles on California Assembly Bill (AB) 525, which proposed the state shift to the water's edge unitary method for foreign-domiciled corporations operating in California and continue to use the WWC method for U.S. MNEs (i.e., domestic worldwide

combination). It was at this point that the unitary tax method became a more prominent issue in California. Seventeen witnesses testified on the unitary issue at the hearing, including representatives of MNEs from the UK, the U.S., and Japan; the Confederation of British Industry; the California Franchise Tax Board; the California Department of Finance; and the California State Office of International Trade. Witnesses testifying against the WWC method stated it was discouraging new investment in the state: since the property factor in apportionment was based on historic costs, new plants and equipment resulted in a disproportionately higher allocation of income to the state. In addition, they argued that although new businesses traditionally lose money in their early years, if these new business were foreign subsidiaries, they would still be taxed by the state if the worldwide operations of their parent companies were profitable.

Domestic-domiciled corporations were not included in the initial round of California bills proposing modifications in the state's use of the unitary method because foreign companies were the most vocal lobbyists against the method. In addition, a foreign-only reform was considerably less expensive to achieve: the FTB estimated that eliminating use of the worldwide combination method for all MNEs would eliminate $400 million in state tax revenue, while eliminating WWC for only foreign-based corporations would cost the state only $25 million.[27] AB525 passed the California Assembly. Then, at the request of the Shell Oil Company, this bill was amended in the California Senate to allow foreign energy companies the option of filing under the water's edge method.[28] However, U.S. oil companies were concerned that their foreign competitors would be more competitive in third-country overseas markets if they were not also subject to California's WWC method. The Assembly thus refused to agree to Shell Oil's amendment, and the bill failed to pass.

California Governor Jerry Brown was a "stout defender" of the unitary method early in his term, and had opposed the UK-U.S. treaty in 1976 at the behest of the executive director of the California FTB.[29] There had been a long-standing tradition in California of defending the WWC method as a means to prevent MNEs from evading state taxes. It was also a popular tax politically, since it generated revenue for the state

while falling to a large extent on non-constituents. However, Governor Brown had a change of heart in 1977 when he traveled to Japan to press for the removal of trade barriers to California agricultural exports. During the discussions, the Japanese raised the counterargument that California's WWC method was a barrier to their trade. The governor returned from the trip convinced that worldwide combination was a bad tax method which should be removed in order to win market-opening concessions from the Japanese. However, Governor Brown did not realise the extent to which the FTB wanted to maintain the method or the institutional strength that the FTB held.[30]

Governor Brown then declared that his previous support of the WWC method had been incorrect since it had been based on "flaky data" he had received from the FTB.[31] This accusation infuriated the executive director of the FTB, Martin Huff, who took personal credit for promulgating the WWC method in California, and strongly believed in the method as a matter of principle.[32] Huff was in a strong position to take a stance against the governor since a special protection existed in California law declaring that the executive director of the FTB could only be removed from office by a two-thirds vote of the California Senate. Huff publicly released the data he had sent to Brown to prove it was correct, embarrassing the governor.[33] Governor Brown then publicly endorsed the provision in the U.S./UK tax treaty banning state use of the worldwide unitary method, while Huff organised opposition to the treaty among tax officials in both California and other states, helping to stall the treaty's passage. Governor Brown and California State Controller Ken Cory, the chairman of the FTB, then proposed legislation eliminating the two-thirds Senate vote requirement for removal of the FTB's executive director, but rather than being publicly forced out, Huff resigned in 1980.

Gerry Goldberg, the new executive director of the FTB, was more conciliatory on the WWC issue. Goldberg realised that supporting the WWC method was a politically untenable position, and opened FTB consideration of Governor Brown's drive to eliminate the method. At this point, the FTB bureaucracy gradually began to realise that, although they would have preferred inaction, they would most likely be forced to modify the method.[34]

In October 1981, the California Franchise Tax Board issued a Task Force "Report on the Unitary Method" in response to issues raised by State Controller Ken Cory, who expressed concern that the tax was a deterrent to investment in California and that it engendered a "disproportionately emotional taxpayer response".[35] The FTB interviewed taxpayers and professional consultants on the tax to conduct an informal survey of interested opinion, which mostly concluded that interviewees disagreed over the application of the unitary method on an international basis. However, those surveyed suggested that the WWC method would be more readily accepted if the FTB was more flexible in its administration of the method and willing to allow factor adjustments to account for different national economic conditions.

In November 1980, the California Assembly Revenue and Taxation Committee held a second hearing on the WWC method in San Diego in the wake of the failure of AB-525. A third hearing was held by the committee in Sacramento in December 1981. Members of the committee became convinced that the WWC method was a problem: however, there was no consensus on how to solve it.

vi) Federal court cases

Bass, Ratcliff and Gretton, Ltd. v. *State Commission*[36] (1924) had seen the U.S. Supreme Court sustain the use of formula apportionment on a foreign-domiciled business operating in the U.S. *Mobil Oil Corp.* v. *Vermont*[37] (1980) allowed the state of Vermont to include dividends Mobil received from its foreign operations in the state's apportionable income base. *Exxon Corporation* v. *Wisconsin*[38] (1980) also sustained U.S. state use of the WWC method, rejecting arguments that the arm's length standard should be used instead.

However, corporations lobbying against state use of the WWC method had seen a victory in the U.S. Supreme Court's *Japan Line, Ltd.* v. *Los Angeles* case in 1979.[39] The court ruled that an ad valorem property tax, based on the average number of days property was present in California each year, was being illegally applied to large cargo shipping containers that belonged to foreign companies. In this case, the court ruled that

California's unitary method resulted in double taxation since the Japanese government, following international custom, had taxed the full value of Japan Line's containers. The court significantly held that the "enhanced risk of multiple taxation"[40] and the risk of foreign retaliation meant that U.S. states had to be especially sensitive in issues of state taxation involving foreign commerce. This was especially true if the state tax "impairs federal uniformity in an area where federal uniformity is essential".[41]

In 1981, *Chicago Bridge & Iron Company* v. *Caterpillar Tractor Company, Illinois Dept of Revenue* attacked the constitutionality of the worldwide combined unitary method in Illinois, and the case went before the U.S. Supreme Court. In an amicus (friendly) brief to the court, the U.S. Solicitor General supported an overthrow of the tax method, stating that the U.S. Departments of Commerce, Treasury, State, and the U.S. Trade Representative had received several complaints from foreign governments about state use of the WWC method, and warning that foreign retaliation could occur. Illinois then repealed its WWC requirement: this case was ultimately dismissed.

On June 27, 1983, the U.S. Supreme Court ruled in *Container Corporation of America* v. *Franchise Tax Board* that California could include all the foreign subsidiaries of a U.S. corporation in the assessment of a unitary tax, but specifically refused to decide whether the state could include in its apportionable revenue base the foreign parents of subsidiaries operating in California. In its decision, the Supreme Court noted the Reagan administration had not filed an amicus brief objecting to California's method of taxation, and this had contributed to its view that the WWC method, as applied to domestic corporations with operations overseas, was not adversely affecting the foreign policy of the U.S. The Reagan administration's decision not to file an amicus brief in the Container Corp. case was seen as taking a new political position, since it was a change from the administration's previous policy of filing amicus briefs in favour of banning the states' application of the WWC method to foreign-domiciled companies.[42] Reagan's belief in states' rights, combined with his strong political links to California, as a powerful former California governor who had supported the states' use of worldwide combination,

contributed to a weakening in federal government support for the arm's length standard method of judging transfer pricing practices.

The Container Corp. decision was a source of considerable alarm to both U.S. and foreign-domiciled MNEs, since, for the first time, it specifically gave the U.S. Supreme Court's backing to state use of the WWC method. MNEs immediately began to press for federal legislation to regulate the state taxation of foreign-sourced income. Many of the U.S.'s foreign trading partners filed diplomatic protests expressing alarm. Additional impetus to these protests was provided by Florida's adoption of the WWC method in July 1983.

The British protested that the U.S. Supreme Court's refusal in the Container Corp. decision to rule on the legality of applying the WWC method to foreign parent corporations was due to the U.S. government's failure to file a brief objecting to California's method of taxation, and that "the outcome of the court's sharply divided (5-3) decision could well have been different had the federal government clearly restated what all parties originally understood to be its position".[43] Attention thus focused on whether the U.S. Solicitor General would support Container's Petition for Rehearing of the case, and Container's attorney wrote to the U.S. Treasury Assistant Secretary for Tax Policy to plead that "the government's involvement is vital to our Petition for Rehearing".[44] The British were particularly alarmed that the Container decision came in addition to the fact that no federal legislation banning state use of the WWC method had been passed since the 1979 U.S./UK tax treaty was signed.[45]

In the wake of the Container Corp. decision, the Canadian Minister of Finance wrote to U.S. Treasury Secretary Donald Regan, objecting to the international application of state unitary taxes, and asking the Treasury Department to resolve the problems posed by state use of the WWC method.[46] The Japanese Embassy in the U.S. also objected to the U.S. State Department over the international application of state unitary taxes,[47] as did the government of the Netherlands.[48]

On December 12, 1984, the European Parliament adopted a "Resolution on Taxation of Companies by American States", urging the U.S. administration to support legislation in Congress exempting foreign companies from the unitary method, and stating that continued use of the method would damage EC-U.S. relations. Further, the resolution stated that since "the principle of unitary tax is contrary to the spirit of the various double taxation treaties and discriminates unfairly against European-based companies with operations in the United States", if the U.S. did not pass federal legislation banning state use of the WWC unitary tax, the EC would consider it justifiable for its member states to suspend their double taxation treaties with the U.S.[49]

The Reagan administration did not introduce federal legislation to ban state use of the WWC method or support Container's Petition for Rehearing. However, in an attempt to stem MNE and foreign government protests, the administration formed an interdepartmental study group under the Cabinet Council on Economic Affairs to study potential solutions to the protests. On September 6, 1983, the Council voted unanimously in favour of federal legislation restricting the states' use of the WWC method and seemed in favour of having the U.S. Solicitor General support Container's Petition for Rehearing.[50]

However, the president rejected the Cabinet Council's recommendation, and instead directed the Secretary of the Treasury, Donald Regan, to form a federal Worldwide Unitary Taxation Working Group to give recommendations on how to deal with growing concern over state use of the WWC method in the wake of the Container decision.[51] This decision was apparently based on state lobbying efforts, Reagan's commitment to federalism, Reagan's opposition to federal efforts to restrict state taxation when he was governor of California, and an emphasis on providing for state revenue needs during his campaign for "fiscal federalism".[52] On October 11, the U.S. Supreme Court rejected Container's Petition for Rehearing.

Box 3: Milestones in the California Unitary Tax Debate

Date	Milestone
1977	California Governor Jerry Brown returns from Japanese trip convinced that unitary tax must be removed to win market-opening concessions from the Japanese.
1979	Congress refuses to back U.S./UK tax treaty allowing British MNEs an exemption from state unitary taxes.
1983	Container Corp. case rules state unitary taxes legal when applied to U.S. MNEs; legality of applying the method to foreign MNEs is left open. Reagan administration does not file an amicus brief objecting to the state tax method.
1984	Worldwide Unitary Working Group. State, federal and business interests attempt, unsuccessfully, to reach a compromise on the unitary issue.
1985	UK threatens retaliation against U.S. MNEs based in Britain over state unitary taxes.
1985	Reagan administration introduces federal legislation mandating an end to state worldwide unitary practices.
1985	U.S. MNEs insist on their inclusion in California's proposed unitary reform bill.
1986	California's Water's Edge Election bill passes. California allows firms to exempt themselves from the state's worldwide unitary method but retains right to disallow an exemption, and forces firms electing the alternative water's edge method to pay an 'election fee'.

Box 3 (continued)

1986	Federal government withdraws pending legislation banning
	state worldwide unitary methods.
1992	Presidential candidate Clinton promises to support California in
	litigation over the state's unitary method.
1993	UK government sends out letters to U.S. MNEs in Britain
	threatening retaliation over California's continued use
	of the unitary method; MNEs increase pressure on
	California legislature to approve further reform of the method.
1993	Second California unitary tax reform bill is passed, ending
	Franchise Tax Board's ability to charge an election fee and
	override a company's election of a water's edge assessment.
	However, California maintains its right to use the worldwide
	unitary tax method.
1993	U.S. Solicitor General files brief in Barclays/Colgate court
	case tentatively supporting California.
1993	U.S. Supreme Court rules in Barclays/Colgate case
	that, since Congress had not passed a law specifically
	outlawing state unitary methods, these tax methods could
	be applied to both U.S. and foreign MNEs.

vii) The Worldwide Unitary Taxation Working Group

The Worldwide Unitary Working Group included federal and state tax officials, the governors of California, Illinois, and Utah, and business executives from IBM, Caterpillar Tractor, Ford Motor Company, BATUS, Exxon, and Pfizer; there were also representatives from the Advisory Commission on Intergovernmental Relations and the National Conference of State Legislatures.[53] The Working Group was announced as a way to produce recommendations that would be "conductive to harmonious international

economic relations, while also respecting the fiscal rights and privileges of the individual states".[54]

The U.S. Treasury Department had led U.S. efforts to champion the arm's length standard on an international basis, and was now invested in preventing the spread of an alternative system. Treasury Secretary Regan was therefore more sympathetic to some form of federal legislation banning state use of the WWC method than the Reagan administration in general. As a result, state representatives did not feel that the Treasury Department was a neutral convenor for the Working Group: they believed the Working Group would be unproductive for state interests, since they felt the Treasury Department's only intention was to attempt to force a change in state tax methods.

Negotiations within the Working Group broke down almost immediately, with both corporate and state representatives starting the talks holding extreme positions in order to maintain leverage during the discussion. State interests wanted to first determine if the WWC unitary method was in fact causing problems for international business and deterring investment in the United States,[55] and attempted to shift the debate to a comparison of the relative efficiency of arm's length and unitary accounting.[56]

Corporate interests, along with the U.S. Treasury Department, started from the position that problems with state use of the WWC method were self-evident, and began presenting solutions which encompassed both foreign and domestic-company concerns. Although all but one of the corporate representatives on the Working Group were from domestic-based MNEs, U.S. MNEs felt their case would be strengthened if it was joined with that of foreign-domiciled MNEs, since the Supreme Court had not yet ruled on the legality of applying the WWC method to foreign-domiciled MNEs: there were hopes that if foreign companies were exempted from state use of the method, domestic companies could successfully argue, under the Commerce Clause of the U.S. Constitution, for an exemption in order to maintain their equity with foreign companies.

The states prevailed in forcing the Working Group's delegated Task Force to collect evidence of harm inflicted on corporations by state use of the WWC method. Assistant Secretary of the Treasury John Chapoton, however, opened the second set of Task Force meetings by strongly stating that the Task Force's role was to propose solution to an obvious problem and that one of the options available to the Group was to suggest federal legislation banning the worldwide combination method.[57] State representatives felt this was direct evidence that the Treasury Department was pressing for preemptive federal legislation, and came close to immediately ending deliberations at that point. After some argument, Secretary Regan agreed that the Task Force should continue "without the consideration of pre-emptive federal legislation of any type",[58] and the Task Force proceeded with the state agenda of determining whether a problem existed with regard to states' application of the WWC method, holding public hearings to gather evidence of harm. State interests also pressed for federal help in auditing the arm's length transactions of MNEs operating in their jurisdictions as a trade-off for switching to the water's edge method. Although states felt the Internal Revenue Service (IRS) was not as efficient as it could be, the IRS had superior capabilities for auditing MNE transfer pricing practices, since the federal government has access to information on corporate activity overseas through its network of bilateral tax treaties.

In an effort by both sides to not be seen as having caused the negotiations to fail, the Task Force agreed to develop a list of six options for solutions to the controversy at the state level. Option 1 had little support, since it would allow only foreign-based business an election between worldwide combination and water's edge methods: this was seen as inequitable for domestic-domiciled corporations. Options 2-6 all provided a retreat from full worldwide combination and differed mainly as to what was included in the state's tax base.[59]

At the final Working Group meeting in May, the states reiterated that they were willing to endorse a partial abandonment of the WWC method in return for increased federal audit assistance. At this time, Secretary Regan indicated the Treasury Department would budget an additional $50 million for international audit examinations.[60] The

Treasury Department's draft Working Group report stated that three principles had been agreed to by the Group, the first of which was "Water's Edge Unitary Combination for Both U.S. and Foreign-Based Companies". The state representatives asked that the final report add the words "under Certain Conditions": these conditions included increased federal audits of MNEs and increased federal auditing assistance to the states. The states further asked that any state substantially complying with any of the options listed by the task force would qualify for federal assistance. The state representatives agreed to sign the Working Group's final report after these requested changes were included.

The revised Treasury report was first submitted to the corporate representatives, who responded by proposing further modifications which had not been discussed with state interests. On July 31, 1984, Secretary Regan, in apparent exasperation, and without advance notice, released his version of the Working Group report, signed by him alone. The Secretary's Working Group Report returned to the Treasury Secretary's original unconditional language in its first principle, recommending that the states change their laws to apply the water's edge combination method to MNEs, and that, only after this had been done, the federal government provide audit assistance to the states on these companies' overseas activities.[61] Regan also recommended federal legislation banning subfederal use of the WWC method if the states did not make progress in changing to the water's edge method within a year.

The states called Reagan's report "a breach of faith", and protested the Secretary's threat of federal legislation and deadline for state changes.[62] The state representatives of the Working Group then submitted both a letter expressing their disapproval and a full copy of the report they felt they had agreed to. On September 4, 1984, the Working Group's final report was released unaltered from Regan's draft version, although in his letter to the president transmitting the report, Regan proposed that the Treasury Department move immediately to implement federal assistance in order to demonstrate the "good faith and sincere intentions of the federal government".[63] The inability of the Working Group to file a final report agreed to by all participants demonstrated the extent of the animosity between state and business groups on the state unitary tax issue.

In response to the recommendations of the Working Group's Final Report and growing lobbying at the state level, in the one-year period after the Final Report was issued, five states stopped using unitary taxation on a worldwide basis, and Utah issued regulations that would end its use of the worldwide unitary method after the passage of federal legislation increasing federal audit assistance to the states.[64] The five states which changed their law included Colorado, Florida, Indiana, Oregon, and Arizona. In addition, Massachusetts stopped using the method after its state Supreme Court struck down the state's use of worldwide combination in *Polaroid Corporation* v. *CIR*.[65] However, California, Alaska, Idaho, Montana, New Hampshire, and North Dakota resisted federal pressures to change their laws.[66]

viii) UK threats of retaliation

In response to the Working Group's failure to propose federal legislation banning application of the worldwide combination method to foreign-domiciled corporations, the increasingly-frustrated British government proposed legislation giving UK Inland Revenue the power to deny Advanced Corporation Tax credits on dividends paid by UK subsidiaries to parent companies "having a qualifying presence" in WWC unitary tax states.[67] This was in direct contradiction to the existing U.S.-UK income tax treaty, which explicitly granted these credits. The British government then announced that this legislation would not go into effect any sooner than January 1, 1987, to allow the U.S. Congress a grace period during which they could enact federal legislation banning state use of the WWC method. However, the threat of UK retaliation was not taken seriously by many U.S. interests, who felt it would constitute an abrogation of the existing U.S./UK tax treaty, and that such an abrogation would constitute discriminatory taxation, legally permitting the U.S. federal government to retaliate against the UK.[68]

vix) Proposed federal legislation

On November 8, 1985, in reaction to the introduction of UK legislation threatening retaliation over the unitary issue, and the failure of six states to pass legislation banning the WWC method in the year following the Working Group's final report, the Reagan administration instructed the Treasury Department to draft federal

legislation mandating a replacement of state worldwide unitary methods with water's edge formulas.[69]

Since all prior attempts to pass preemptive federal legislation on the unitary issue had failed, many doubted this legislation had the political support needed to pass after so many states had already revoked their worldwide unitary tax requirements. Most observers felt the federal government remained wary of treading into an area of traditional state sovereignty.[70] In addition, the proposed legislation most likely would have faced strong congressional opposition if it had come to a vote since it prohibited states from taxing intracorporate foreign dividends: at the time, 37 states counted these as part of their anticipated revenues, and the resulting revenue loss would have been a significant impediment to the bill's passage.

Further pressure came from the federal government on January 30, 1986, when U.S. Secretary of State George Shultz wrote to the governors of Alaska, California, Idaho, Montana, New Hampshire, and North Dakota, asking them to stop using the WWC method. He argued that the foreign policy interests of the U.S. were being threatened, since the states' method had become a point of conflict with foreign countries, and repeated arguments from U.S. trading partners that the WWC method created a risk of double taxation which was distorting investment decisions and reducing the flow of foreign investment into the U.S. Schultz stated that the U.S. federal government had long promoted the arm's length standard in its Internal Revenue Code and bilateral tax treaties, and that the ALS was prescribed in the United Nation's and Organisation for Economic Cooperation and Development's model income tax treaties.

In June 1986, alarmed that neither of the congressional bills initially proposed in December of 1985 had yet come to a vote, British Members of Parliament went to Washington D.C. to lobby U.S. Treasury Secretary James Baker and U.S. Congressional leaders for federal legislation banning state use of the WWC method. Michael Grylls, chairman of the Conservative Trade and Industry Committee, stated the administration "might have done more to get things moving".[71] In July of 1986, Michael Grylls, Tony

Blair, Labor's Deputy Treasury and Economic Spokesman, and Ian Wrigglesworth, an Economic Affairs Spokesman for the Social Democrats, sent a letter to the U.S. Treasury Secretary stating that if there was not substantial progress made on the issue by the end of 1986, UK retaliation would be inevitable. After much foot-dragging, hearings on the congressional bills were scheduled for September 29, 1986.

x) Corporate lobbying efforts in California

It had become conventional wisdom in California that as long as the state was seen to be making an effort to discuss modifications of its WWC method, the federal government would not act to ban the method.[72] California bureaucrats felt they were in a strong position on the issue, since both state and national courts had been clear in ruling that use of the WWC method was a state matter unless the federal government explicitly banned the practice, and Congress had not passed legislation banning the method. However, corporate lobbying against the method kept the issue prominent at the state level. Many foreign and domestic companies voiced the view that the WWC tax method was a deterrent to investment in the state, but the perception was widely held that Japanese MNEs were the strongest objectors to state use of the method. The Japanese also commanded a great deal of attention in California at that time since they had become heavily involved in the state's economy during the early 1980s.[73]

Sony Chairman and CEO Akio Morita repeatedly stated that California's use of the WWC method was stopping Sony from investing in the state beyond its Rancho Bernardo television plant, and the company made prominent new investments in other states which did not use the WWC method.[74] In 1984, in conjunction with the Electronic Industry Association of Japan, Morita stated that Sony's continued contribution to California's economy was now in serious jeopardy, and announced that 100 Japanese firms were considering investing nearly $1.5 billion in California, with the potential to create around 11,000 new jobs in the state. However, this investment would come only if California revoked its mandatory WWC method.[75] Along with Sony, Kyocera, a major electronic components manufacturer, led the contingent of Japanese MNEs lobbying against the WWC method. In 1982, Kyocera stated it would not make further investments

in California until the state's unitary method was reformed, and also made very public investments in other states which it declared were in protest over California's use of worldwide combination.[76]

In addition, many large U.S. MNEs also lobbied to revoke California's use of mandatory worldwide combination.[77] IBM opposed the method on the grounds that it unfairly penalised MNEs compared to companies with purely domestic activities. IBM had lobbied successfully against Minnesota's use of the WWC method by threatening no further investment in its Rochester, Minnesota plant unless the tax method was revoked.[78] In late 1985, IBM moved an operation with 500 jobs from San Jose to Arizona, a state which did not use the WWC method. Moreover, the U.S. Chamber of Commerce started a campaign to 'red-flag' states where a WWC method was in effect, sending out bulletins suggesting that its members avoid locating in these areas.[79]

xi) California attempts at legislation

California state bureaucrats argued that investment in the state had not slowed despite protests over California's use of the WWC method: they were confident that the reason MNEs were so concerned about the method was that they felt they had to maintain a business presence in California.[80] They feared unitary reform would be a huge revenue drain for the state and be perceived by the public as a tax break for large companies.[81]

However, California state government officials grew more became concerned when MNE threats of disinvestment were joined, in 1986, by threats of UK government retaliation and preemptive U.S. federal legislation. At the same time, California Governor Deukmejian had been directly prompted to reform the state's tax method. When the governor's chief of staff, Steven Merksamer, went on a four-day trip to Japan in August 1986 to try to persuade Japanese officials to lift tariffs and restrictions on California agricultural imports, he was met with demands that California drop its WWC tax method. Merksamer said "I was told, point-blank, that if this (method) was changed, there would be substantial investment in California...It is very important, if we're going to be able to attract that foreign investment, that we deal with this issue".[82] It became increasingly hard

to avoid the idea that it would be worthwhile for the state to modify its tax method.[83] In addition, Governor Deukmejian, a Republican, was a strong supporter of President Reagan. Deukmejian wanted to avoid causing foreign policy problems which would embarrass the Republican president, and the confrontation that federal legislation banning the state's tax method would involve.[84]

In May 1984, after the federal Working Group had concluded its negotiations but before it had issued its final report, Deukmejian announced he would seek to modify California's unitary tax method. Deukmejian made reforming the state's unitary tax method a keystone of his 1984/85 legislative program, which was designed to encourage foreign investment in the state. In 1984, Governor Deukmejian formed a working committee on the issue of unitary reform, comprising representatives of California's executive branch, legislative branch, and business community. This was a departure from traditional legislative procedures, but Deukmejian sought to reach a consensus on what had become a politically divisive issue.[85]

Since the Japanese had originally led the fight against the WWC method in California, the working committee discussed several options for using a removal of the WWC method to specifically force the Japanese government to remove trade barriers to California products.[86] However, the Senate legislative counsel concluded that it would violate the Commerce Clause of the U.S. Constitution to exclude activities in a foreign country from the state's apportionable income base depending on whether the foreign country concerned was guilty of erecting trade barriers against state products. A proposal to institute a statutory preference in state public purchases against goods from discriminatory countries was also seen as potentially unconstitutional. Another proposal, to have the California World Trade Commission publish a list of discriminatory countries, was viewed by the counsel as constitutional, but probably ineffective. It was also seen as constitutional to condition state water's edge legislation on the federal government's adoption of a plan to better identify and act on trade discrimination by foreign countries;[87] however, this suggestion was never acted on. In July 1984, the Japanese announced an Action Program to promote market accessibility, including tariff reductions on

agricultural and fishery products, as well as zero percent tariffs on industrial products. The Japanese government stressed to Senator Alquist that it was through such internal initiatives that foreign complaints about access to the Japanese market would be addressed, rather than through responses to "external demands".[88]

California Senator Alfred Alquist (D-San Jose), chairman of the state Senate Budget and Fiscal Review Committee, decided to introduce legislation limiting California's switch from the WWC method to the water's edge method only to foreign-domiciled businesses, since protests at both the federal and state level had been led by foreign MNEs. In addition, it was felt that emphasising that the reform was needed to stop international condemnation would help state legislators avoid protests that the change was simply a tax break for large companies.[89] Once it became apparent that the steering committee was close to agreement on a solution which allowed only foreign companies the option of a water's edge election, companies in Silicon Valley's growing high-tech community joined the Committee on State Taxation, which had been lobbying against state use of the WWC method since the 1970s, to protest the proposed change.[90] The Silicon Valley companies argued that if Japanese MNEs received a tax break in California, it would be increasingly difficult for U.S. firms to remain competitive. Senator Alquist, whose constituency of Santa Clara county included Silicon Valley, quickly realised his exclusion of U.S. MNEs was a mistake, and changed the legislation to allow domestic-domiciled companies the option of a water's edge election.[91] He introduced legislation, SB85, on December 6, 1984, which allowed both foreign and domestic-domiciled companies in California to permanently elect either the water's edge or the WWC method of assessment.

However, many U.S.-domiciled MNEs objected to SB85's stipulation that California would continue to tax the dividends U.S. MNEs received from their overseas subsidiaries but not the dividends received by the U.S. subsidiaries of foreign-domiciled MNEs.[92] Despite these protests, the Alquist bill was seen as having a high chance of passing since, as the lowest-cost alternative presented before the state's unitary tax working committee, it had the governor's approval.[93]

In an effort to somewhat mollify U.S. MNE groups on the issue, the unitary reform working committee introduced AB1300 in the Assembly as the successor to SB85.[94] This bill offered relief on the taxation of foreign-sourced dividends for U.S. MNEs in the form of a 67-cent deduction against foreign dividends for every dollar of increased investment or employment in California.

Despite this revision, U.S. MNEs still objected to AB1300's inclusion of their foreign-sourced dividends under any circumstances. The California Business Council (CBC) ran newspaper advertisements around the state protesting the legislation's inclusion of U.S. companies' foreign-sourced dividends in the water's edge assessment, and urging U.S. MNEs to protest the bill before the California Assembly Revenue and Tax Committee. This advertisement prompted The Sacramento Bee newspaper to write an editorial supporting the exclusion of foreign-sourced dividends from the water's edge election of U.S. MNEs. In August 1985, the CBC sent an "Uncle Sam" character to the offices of state legislators to lobby against SB85 and AB1300. The character delivered, in baskets covered in the American flag, a sample of six industry group products the CBC said were subject to severe trade barriers and market access restrictions abroad. The CBC claimed that most of the foreign companies which would benefit under the proposed bills came from countries which restricted the access of U.S. business to their markets and subsidised the export of their country's products to the U.S. Although AB1300 was characterised as a bill which only benefited foreigners, according to the FTB, two-thirds of the bill's total tax relief would go to domestic-domiciled companies.[95]

Assemblyman John Vasconcellos (D-San Jose), the Chair of the Assembly Ways and Means Committee, who had been lobbied heavily on this issue by both COST and the CBC, along with his Silicon Valley constituents, then refused to back the proposed legislation, and "blew up the deal"[96] agreed upon by the state working committee in June 1985. Vasconcellos drafted a competing bill in California's lower legislature, AB2922, which excluded the foreign-sourced dividends of U.S. corporations electing water's edge from state taxation, and granted unitary relief in three stages instead of all at once. This bill was supported by most U.S. MNEs over Alquist's bill. The fact that Vasconcellos and

Alquist were from the same congressional district of San Jose, whose constituents, Silicon Valley firms, were active on the WWC issue obviously drove both legislators to press for unitary reform.[97] The coincidence that the two representatives from this district were also chairing the legislature's two fiscal committees was important in giving the unitary reform movement political momentum.

However, since Vasconcellos' modifications of Alquist's proposals raised the bill's cost, it stood a high chance of being vetoed by Governor Deukmejian, who was standing for reelection in 1986, and did not want to be accused of giving up a large amount of state tax revenue.[98] The governor insisted that the total cost of unitary reform should stay in the $200-300 million range: the FTB estimated that the version of water's edge election proposed by Senator Alquist in SB85 would cost the state $200 million,[99] while Vasconcellos' AB2922 would cost $585 million.[100] Deukmejian also objected to Vasconcellos' foreign dividend exemption for U.S. MNEs on principle, since he felt it would reward U.S. firms for creating jobs overseas. California Senate President David Roberti (Democrat-LA) also opposed the exemption, calling it "chutzpah" for U.S. MNEs to ask for tax relief for exporting jobs.[101]

xii) Impact on state revenues

In 1985, California had experienced several years of budget surpluses. However, there were growing fears in the California legislature that the U.S. federal budget deficit could combine with the Reagan administration's push for fiscal federalism to renew revenue pressures on the state. The debate over unitary reform in California quickly became a debate over whether the state could afford the resulting revenue loss. There was also concern that the public would view unitary reform as a concession to large corporate interests.[102]

To some extent, the debate over unitary reform pitted small business against big business.[103] Since multinational enterprises in California were outnumbered by small and medium-sized businesses with no overseas activities, most companies operating in the state would have preferred the continued use of the WWC method over the overall

increase in business taxes they feared might result from a state revenue loss due to unitary reform. Arguments over the repeal of mandatory use of the WWC method increasingly became a standoff between those who feared the loss of state tax revenue from unitary reform, and those who felt removing the unpopular tax method would attract new MNE investment to the state, increasing California's overall tax revenues. Although tax methods are not generally the predominant factor influencing most MNE investment decisions, the unitary method, which engendered a "disproportionately emotional taxpayer response", became increasingly to be seen as a signal of the attractiveness of a state's regulatory environment for business.[104]

However, it was difficult to judge the increased amount of long-term investment which might result from reform of the state's unitary method, since a state's tax method is usually only one of many factors investors take into account.[105] The economist Larry Kimbell of UCLA issued a report stating that repeal of the mandatory WWC unitary method in California would lead to an increase of around $3 billion a year in investment in the state. However, he stated that the state's prospects for increased investment were good even if the WWC method was not removed.

In addition, the California legislature relied on FTB estimates of projected revenue loss when considering the revenue impact of modifications to the state's use of the WWC method. Many MNEs in favour of reform felt that the FTB, which supported the use of worldwide combination, attached very high estimates of projected revenue loss to any retreat from the WWC method.[106] FTB estimates were hotly contested by MNEs, since most estimates depended heavily on the number of companies it was estimated would elect water's edge combination if worldwide combination was no longer mandatory. In addition, FTB estimates did not take into account the possibility of an increase in state tax revenue from new investment attracted to California by the removal of an unpopular tax method, since the FTB claimed the impact of unitary reform on the future location decisions of MNEs was impossible to quantify, despite public promises of increased investment from several Japanese firms.

However, the FTB maintained the upper hand in any disputes over accuracy of data, since the Bureau held that the state tax return information it used to generate revenue estimates was confidential, and refused outside access to their numbers.[107] Outside estimates were therefore dependent on publicly available information or figures volunteered by companies, and always suffered from charges of being less accurate.[108]

xiii) The election fee

AB1300 was quickly dubbed the unitary tax "quid pro quo" bill since it levied an annual fee of 2% of a companies' payroll, property, and sales revenue in California on firms opting for water's edge assessment instead of worldwide combination; this fee was seen as being the "price" MNEs had to pay the state for unitary reform.[109] It was estimated the election fee would generate $67 million annually towards a Unitary Fund, of which 80% would go to infrastructure development in California communities seeing increased foreign investment, and 20% to promote California exports. The fee became integral to having the legislation perceived as a fair solution, since it solved the primary political argument against reforming the WWC method, that WWC reform was a tax break for big business.[110] Once the issue of a fee was raised, a political solution which did not include the election fee became practically unworkable.[111]

Although the Japanese viewed the fee as a cost they were willing to pay to achieve unitary reform, and indeed, Sony Corp. had originally proposed the idea of a fee to Senator Alquist,[112] the British felt that an election fee was "an anathema".[113] Even though it would generate a very small amount of money, British companies felt the fee added insult to injury since, in their view, the California legislature was admitting they were wrong by agreeing to modify the WWC method.[114] However, MNE protests against the fee only gave legislators more political protection to argue that they had not completely given in to corporate interests.[115]

xiv) Foreign vs. domestic lobbying

Foreign-domiciled MNEs, in particular the Japanese, originally led protests against the WWC method in California, and organised quickly to form unitary tax lobby

groups. Foreign MNEs also placed pressure on the U.S. federal government through formal protests from their home governments: the U.S. federal government was therefore more insistent that states find a unitary reform solution for foreign-domiciled companies. In addition, foreign MNEs had a stronger legal case to make against the WWC method, since U.S. courts had not yet ruled on the legality of applying the WWC method to foreign MNEs. Foreign companies could further claim that worldwide combination constituted an extraterritorial application of state law, and forced them into onerous recordkeeping and currency conversion requirements which U.S. companies were not subject to.

The stronger position held by foreign MNEs contributed to an important difference in their lobbying tactics: they made more threats to leave California for other states which did not use the WWC method. U.S. MNEs felt they could not as plausibly threaten to leave California entirely, especially if their headquarters were in the state, and that any arguments in this direction would cause them to lose credibility with California legislators. U.S. MNEs did threaten not to increase their existing investment in California, although this was based not just on the state's use of the WWC method, but on general arguments that other states had regulations more friendly to business. Domestic-domiciled companies tended to simply list the WWC method as one of the factors affecting their decision to locate in a particular state.

U.S. companies fought for their inclusion in unitary reform legislation mostly on the principle of equity with foreign companies. COST and the California Chamber of Commerce in particular argued that, in an increasingly internationalised economy, U.S. companies had to be on an equal footing with their foreign competitors. Further, they argued that domestic companies were the state's true constituents. The constituency argument was not particularly effective: there was not a great deal of backlash at this time against foreign MNEs in California, and the WWC method was viewed by state legislators as equally onerous on both foreign and U.S. MNEs. However, after U.S. companies pushed to be included in SB85, foreign companies realised it would be politically difficult for them to attain unitary reform legislation in California that could be

portrayed as a foreign-only tax break; therefore, U.S. MNE would have to be included in any unitary reform effort.

Domestic companies, however, continued to view foreign MNEs, especially the Japanese, as a threat to their inclusion in unitary reform. Although the Organization for the Fair Treatment of International Investment coordinated somewhat with U.S. companies, and there were a few lobbying groups, such as the California Chamber of Commerce and the California Manufacturer's Association, which included both foreign and domestic companies, foreign and domestic companies never really came together on the unitary issue, and the various nationalities remained fairly separate in their lobbying efforts.

xv) Diverse foreign lobbying tactics

Foreign MNE lobbying groups argued that the WWC method incorrectly assumed homogenous economic conditions worldwide, was contrary to the internationally-approved arm's length standard, and resulted in double taxation. They also played on the fear of threatened British retaliation against U.S. business in the UK, and argued the WWC method caused a drop in worldwide economic efficiency since it distorted international investment patterns.

The Japanese lobbying effort against California's WWC method was led by Sony and Kyocera; Sony also chaired the California Unitary Coalition, and its California branch, the California Investment Environment Committee, which consisted solely of Japanese firms. The Japanese tended to use corporate lobbyists as opposed to more formal approaches from their government, since the Japanese government and business were combined within the Keidanren.

The Japanese were most concerned with the cost of the WWC method, since their firms were making big new capital investments in California: these new subsidiaries often had high start-up costs, resulting in losses in California which were being taxed under the WWC method against huge parent-company profits in Japan. In addition, Japanese

companies argued that payroll comparison between Japanese and U.S. companies were inaccurate since companies in Japan had a very different system of fringe benefits. The Japanese also lobbied extensively on a more direct level to change California's law, spending so much money on lobbyists and campaign contributions in the 1980s that their unitary lobbying was dubbed 'Wada-gate' after Chris Wada, Sony Corp.'s top executive in California.[116]

British interests were seen as less willing to compromise on unitary tax reform than the Japanese, since British companies were much more concerned with the principle that the WWC method was contrary to international norms. The British primarily used political figures as lobbyists: parliamentary delegations, Margaret Thatcher, and members of the British consulate in San Francisco. UK companies were also not as financially harmed as the Japanese by the method, since most of their subsidiaries in California were long-established. They therefore also could not threaten to withdraw their investments as plausibly as the Japanese.

There was a lingering feeling among state interests that a lack of appreciation for federalism among British interests may have been a contributing factor to their intransigence on state use of the WWC method. There was a sense that the British government did not really understand federalism, and did not understand how California, a subset of a friendly nation, could be punishing English companies in contravention of international norms. The UK government in fact asserted that the "states' reach cannot exceed the grasp of their sovereign, the national government".[117] However, under U.S. federalism, "the Tenth Amendment ensures California's sovereignty, thereby creating a dual system of sovereignty between California and the federal government under which neither entity may impair the sovereignty of the other".[118]

However, not all foreign MNEs in California spurned the WWC method: British Petroleum spoke in favour of the WWC method at hearings in the California legislature, since the method lowered the company's state tax bill.

xvi) Moves towards a solution

Reform of California's unitary tax method had been discussed extensively for several years, and most legislative observers thought neither the Vasconcellos or Alquist bill would pass in 1986. In particular, since 1986 was an election year in California, state legislators were seen as reluctant to repeal the WWC method for fear they would be blamed for the resulting loss in state tax revenue. Meanwhile, jokes circulated that the continuing debate over unitary reform had become a "cottage industry" in California.[119] Neither lobbyists nor legislators were seen as having an incentive to resolve the issue quickly, since it would have stopped a large source of their funding. Campaign contributions over the issue approached $500,000 in 1985, and Assemblyman Tom Hayden, at one point in 1985, jokingly proposed an amendment to SB85 that it could not become operative until every registered lobbyist in Sacramento had been hired to influence its passage or defeat.[120] Unitary reform was described as a "bonanza" for the more than 100 corporate representatives and lobbyists focusing their attention on the bills.[121]

At the same time, there was a fear that if California did not act, the federal government might. In March 1986, Vasconcellos warned that the pending U.S. federal legislation, initiated to allay foreign government protests, could ban the unitary tax outright and force California's hand on the matter unless the state acted quickly in some way. In early 1986, Senator Alquist had also written to Assembly Vasconcellos concerned that the upcoming state elections and budget process in late 1986 would supplant attention on unitary reform. He agreed with Vasconcellos that a failure to act soon might force federal action. On May 15, 1986, California's Assembly passed a revised version of Alquist's bill which incorporated Vasconcellos' gradual phasing-out of the WWC tax method.

The State Senate sent the Assembly bill to a two-house conference committee to find a compromise with Alquist's Senate bill. The legislative panel publicly stated they were anxious to reach a compromise quickly because a subcommittee of the U.S. Senate had scheduled a September 29th hearing on federal legislation banning state use of the

WWC method. The passage of this federal legislation might mean California would have to absorb the full brunt of the resulting revenue loss without being able to legislate any offsetting revenue sources tied to unitary reform.[122] Further, the state's strong fiscal position served to make the revenue loss from reform palatable if the legislation would satisfy both foreign and domestic companies and dismiss the issue. A compromise was reached to allow a 75% tax deduction for the foreign-sourced dividends of U.S. MNEs, and both foreign and domestic companies agreed to support the bill.

xvii) The 1986 Water's Edge Election Bill

The final Water's Edge Election Bill, unanimously agreed upon by the state conference committee on August 21, 1986, was seen as a true compromise. It allowed all companies, regardless of nationality, to elect to file under the water's edge or WWC method for a period of 10 years. Governor Deukmejian was reassured that the foreign dividend exemption would not cause jobs to be exported abroad by the insertion of a formula tying the dividend exemption to increases in an MNE's U.S. payroll proportionate to its foreign payroll.[123] Firms above a minimum size which elected to use the water's edge assessment also had to file a domestic disclosure spreadsheet every three years to show their total U.S. income and describe how this income was apportioned throughout their operations in the U.S. The California Franchise Tax Board could, however, disallow a firm's water's edge election and force it to file under worldwide combination if it did not provide the necessary information required, or if the FTB determined that it could not prevent a company's tax evasion with the audit tools available.[124] The bill also required that MNEs electing to use the water's edge method pay an annual `election fee' of 3% of their combined payroll, property, and sales in California.[125]

Tax relief granted to MNEs under this bill through the ability to elect a water's edge assessment was estimated at $232 million, but since the election fee provided $38 million and the closure of loopholes to conform California's tax code with recent federal tax code changes supplied an additional $111 million, overall, the legislation cost the state an estimated $83 million in lost revenue.[126] This was considered quite small in the face of

the $4.3 billion California had collected in bank and corporation taxes in fiscal 1984-85. It also did not take into account any rise in state tax revenue from increased investment in California after the reform of an unpopular tax method. In the end, it was estimated foreign firms would receive 25% of the tax relief provided under the legislation; the remainder, over 75%, would go to American firms.[127] Governor Deukmejian signed the bill making the WWC unitary tax method an optional election on September 5th, 1986, and the law went into effect on January 1, 1988.

xviii) Foreign reaction to the law

Japanese MNEs seemed fairly content with California's unitary reform legislation, despite warning they would continue to lobby for a complete revocation of the WWC method. "We are satisfied 80 percent by the unitary tax change, but not 100 percent," said Masami Tashiro, a Keidanren official.[128] A statement by Sony's CEO on behalf of the Keidanren said that the legislation "will encourage investment in California by foreign and domestic multinational corporations...we expect that investment in California by Japan and other countries will be accelerated".[129] The Keidanren announced it would send a study mission to California in the near future, presumably to look for new investment opportunities now that the tax was optional, and the Japanese Ministry of International Trade and Industry stated that the unitary reform legislation would help promote Japanese investment in California.[130]

Four days after the bill was signed into law, the Japanese MNE Kyocera announced it would expand operations at its manufacturing plant in California. One week after the bill passed, Sony announced it would spend about $30 million over the next three years to expand its California television factory.[131] Sony then announced it would build a new $10 million joint venture sales/service facility in suburban Los Angeles. The chairman of Sony Corp. of America said the two investments were "Sony's answer to its pledge to bring production to the state", and mentioned the weakening dollar along with reform of the state's unitary method as factors which had prompted the company's decision.[132]

British firms, however, were less enthusiastic about the state's reform, since California could theoretically still force the use of worldwide combination on foreign companies, and MNEs were being charged a fee to opt out of a system the UK government considered a violation of extraterritoriality. They further protested that worldwide combined reporting had nominally remained California's primary method of taxing multinational companies, offending the international norm of the arm's length standard. The UK Chancellor of the Exchequer stated he was disappointed with the law, but announced the UK would now retaliate only if other U.S. states started to use the WWC method. Nonetheless, retaliatory UK legislation remained on the books to be available at a later date, and the British government continued to state that California's tax system was contrary to accepted international tax practice and to urge the U.S. federal government to take action to ban state use of the WWC method.

Howard Davies, director general of the Confederation of British Industries, stated that while "the CBI welcomes this positive move," California's legislation "does not solve the problems of the past": refunds for taxes already paid under the mandatory WWC method, a sum then estimated at 600 million pounds.[133] The Organization for the Fair Treatment of International Investments also protested California's use of the election fee, and continued to lobby, without success, for the fee's elimination before the law went into effect in 1988. "Today, the Japanese are as satisfied as anyone", California Chamber of Commerce counsel Fred Main stated. "The British are less satisfied. It's going to be an issue for a long time".[134]

xix) Domestic reaction to the law

Domestic proponents of unitary reform argued the law was overwhelmingly positive since it removed an obstacle to investment in the state. In signing the legislation, Deukmejian stated the new law "will send out a very clear message to people around the state and around the world that California intends to continue to be the job-creating capital of the nation".[135] He declared that California was "going global", and stated that California's removal of a barrier to international trade would be matched by the state's toughness in knocking down restrictive trade barriers in other countries.[136] In general,

U.S. MNEs agreed with foreign MNE objections to the election fee, and to the FTB's ability to disregard a water's edge election. At the same time, 80/20 companies, U.S. MNEs with more than the 80 percent of their operations overseas, objected to the new law since they would remain subject to the WWC method while their main competitors, overseas firms in foreign markets, would not.[137]

The strongest domestic critics of the law argued it cost the state too much money. "This is nothing more than welfare for corporations", declared Assemblyman Jack O'Connell.[138] Senator Tom Hayden, a long-time opponent of the bill, stated such a large "tax break" for multinational corporations was "voodoo economics".[139] Bill Bennett, a member of California's Board of Equalization, noted that Sony Corp. had given more than $46,000 to state officials during the 1985-86 legislative session, and called the bill "a tribute to the lobbying power of the foreign nationals. They bought the legislation, it's as simple as that".[140]

xx) Withdrawal of federal legislation

At the U.S. Senate Finance Subcommittee hearings of September 29, 1986 on federal legislation to reform state use of the WWC method, the Reagan administration formally recommended the withdrawal of the legislation in the wake of California's new law. Now, only Alaska, Montana and North Dakota still employed mandatory worldwide combined unitary taxation. "The sheer size of California's economy, and sheer number of multinational corporations operating there, makes its final resolution of the issue most significant to the debate on the federal level," Senator Pete Wilson (R-CA) stated.[141] In addition, California's unitary reform was seen as symbolically important: since California and New York state companies conduct the most international business, their state laws are generally taken as the standard for all U.S. MNEs.

However, J. Roger Mentz, Assistant Secretary of the Department of Treasury, stated at the September 29th hearing that the administration still had some "serious policy concerns" with the California bill, including the provisions for payment of an election fee, 80/20 corporations, and foreign dividends.[142] He further noted that if progress was not

made towards changing these provisions, the federal government might reintroduce preemptive legislation in the future.[143] Although bills to further restrict U.S. state use of the WWC tax method continued to be annually introduced at the federal level through 1993, Congress did not show any interest in legislating on the issue.

xxi) Continued lobbying efforts in California

In the end, not as many companies as predicted elected to file under the water's edge method in California since they felt the restrictions attached to its election were too onerous.[144] In particular, the law's requirement that companies elect to use the water's edge method for a period of 10 years was seen as an undue constraint, since most companies were unwilling to plan that far in advance.[145] Many companies also did not elect to use the water's edge in order to avoid paying the election fee.[146]

Lobbying efforts for unitary reform in California decreased significantly after the 1986 Water's Edge Election Bill passed. Although most lobbying groups which opposed the state's use of the WWC method were not satisfied with the final bill, there was a recognition that the California legislature felt that unitary reform had taken place, and there was not enough political momentum to drive forward further changes.[147] Many of the issue-specific lobbying groups most active on unitary reform, including the Organization for the Fair Treatment of International Investment and the California Business Council, disbanded after the bill's passage.

Those who wanted to press the unitary reform issue further placed their faith in continuing court cases to rule state use of the WWC method unconstitutional, feeling this was the only way to obtain a complete removal of the method.[148] Several companies refused to file under the water's edge method in the belief that the restrictions surrounding the election of the method would soon be declared unconstitutional.[149] Among British interests, in particular, there was an assumption that because the U.S. administration was against state use of the WWC method, it would be ruled unconstitutional by U.S. courts.[150] This assumption was fueled by the continued British belief that it was lack of support from the Reagan administration which had led to a U.S. Supreme Court ruling in

favour of the states in the 1983 Container Corp. case.[151] However, the fact that a California legislative solution had been reached, even if it was incomplete, relieved pressure on the courts to rule against the states.[152]

xxii) Investment promotion turns to negotiation

In Governor Deukmejian's annual State of the State address after the passage of California's 1986 unitary reform legislation, the governor noted: "we recently addressed a barrier to investment in our state, which many (foreign investors) had requested us to do, the unitary method of taxation. And I will ask them now to respond to our showing of good faith by lowering their own trade barriers and increasing their investment in our state".[153]

During Deujkmejian's 1987 trip to Japan, the governor's advisors stated that after the Japanese had complained about the WWC method, California had changed its law, and "now we want them to put their money where their mouth is" by removing barriers to California agricultural products, especially rice.[154] Sony CEO Morita responded that "When we were tackling (a repeal of) the unitary tax method, we took as long as 10 years, and exercised patience...We hope our American trading partners will exercise similar patience".[155]

Deukmejian then threatened that California would revert to compulsory worldwide unitary taxation if the Japanese did not make more investments in California and open up their markets to California products; at the same time, he stated California would consider eliminating the state's water's edge election fee if the Japanese increased their investment in California. He said, referring to the unitary system, "we don't have the jurisdiction over a lot of these international questions of trade and the like, but there are some things we can do. And this is an option. We're going to try to be as influential as we can".[156] The governor stated that he viewed his role not as negotiating directly with the Japanese government to remove trade barriers, but as simply applying pressure.

Deukmejian also pressed Taiwan to toughen its intellectual property rights laws to help California manufacturers, and visited Europe to press for reduced trade barriers, new markets for Californian exports, and increased foreign direct investment in the state. In a speech to the London Chamber of Commerce, he declared that California expected to see more investment by British companies after the reform of the state's unitary method.[157] Asked whether California would retaliate against countries which did not provide equal access to California products, the governor said, "These are options that have to be considered down the road".[158]

xxiii) U.S. 1992 federal transfer pricing regulations

The same year that California passed the Water's Edge Election Bill, the U.S. federal government modified federal transfer pricing regulations further away from a complete endorsement of the arm's length standard (ALS). The Tax Reform Act of 1986 modified Section 482 of the U.S. Internal Revenue Code to declare that profit on transfers of intangible goods, such as intellectual property, should be allocated 'commensurate with the income' attributable to the intangible good. This established that the Internal Revenue Service could examine the income attributable to a company's factors of production in determining the company's tax payment. This prompted criticism from U.S. states that the federal government should not be criticising state use of formulary apportionment methods since, by looking at underlying factors of production, the federal government was tacitly admitting that formulary apportionment methods were more accurate. The 1986 Internal Revenue Code revisions also prompted criticism from MNEs and foreign government that the U.S. was retreating from its endorsement of the ALS.

By the 1980s, the persistence of low taxable net income among foreign-controlled companies in the U.S., compared to U.S. firms and to standard worldwide rates of return, had become controversial. Suspicions grew that these tax underpayments were due to transfer price manipulations.[159] These suspicions increased with worries over the rising U.S. budget and trade deficits: the IRS estimated that transfer price manipulation by foreign MNEs resulted in an annual loss of US$ 3 billion at the federal level.

In 1992, U.S. Representative Dan Rostenkowski (D-IL) and Willis D. Grudison, Jr. (R-OH) proposed the Foreign Income Tax Rationalization and Simplification Act, HR 5270, which would have effectively eliminated the use of the arm's length standard at the federal level and instead required U.S. companies with at least 25 percent foreign ownership to pay an alternative minimum tax on 75 percent of the average profits earned by U.S. enterprises in the same industry. The Rostenkowski/Grudison bill did not pass, but it focused further attention on this area.

In 1992, the IRS proposed new regulations which attempted to extend the 'commensurate with income' principle to tangible goods, stating that an MNE's operating income should fall within "the range of profits that would have been earned by similarly situated uncontrolled taxpayers engaging in comparable uncontrolled transfers".[160] This was known as the 'comparable profit interval' method (CPI), and it was to be used to double-check all other methods of setting transfer prices.

MNEs and the OECD Committee on Fiscal Affairs widely criticised the proposed U.S. regulations as a departure from the ALS.[161] Accordingly, when the IRS regulations were issued in temporary form (as the OECD had requested) in 1993, they stated that firms should use the "best method" to give "the most accurate arm's length result", and no longer required the CPI method to be used to double-check other assessment methods: it should only be used if all other methods were deemed unreliable.[162] However, the CPI method was still listed as a possible means of evaluation. To counteract the increased flexibility in judgment, penalties for transfer price manipulation were increased. The 1993 IRS regulations were criticised by the International Chamber of Commerce's Commission on Taxation as continuing to give the comparable profit interval method too high a status at the expense of the ALS.[163] These temporary regulations remain in place today.

xxiv) Barclays Bank's initial suits

Barclays Bank brought suit against the California Franchise Tax Board in 1984, stating that in 1977 the FTB had assessed the bank liable for $250,000 more in taxes than it should have; Barclays paid the tax, but sued for a refund on the grounds that applying

the WWC method to the overseas income of foreign-based corporations was unconstitutional. Barclays argued that use of the WWC method resulted in international double taxation and violated the Foreign Commerce Clause of the U.S. Constitution by interfering with the U.S. federal government's ability to 'speak with one voice' when regulating commercial relations with foreign governments. Barclays further argued the WWC method violated the Due Process Clause of the Constitution since it resulted in unreasonably high and burdensome taxes.

In June 1987, the California State Superior Court ruled in the Barclays Bank case that the WWC unitary tax method was unconstitutional when applied to foreign-based MNEs, since only the U.S. Congress, not the state, had the power to regulate commerce with other nations. Additionally, the Superior Court found that that WWC reporting requirements for foreign-based MNEs violated the due process clause because, due to the difficulty of producing accounting data on foreign activities acceptable to the FTB, the only way Barclays could comply with California's tax method was by "supplication and negotiation" with the FTB.[164] The Franchise Tax Board immediately appealed the decision.

On November 30, 1990, the 3rd District Court of Appeal upheld the Superior Court's judgment against California in the Barclays Bank case, and the court's power to do so based on the dormant commerce clause theory, since the states' use of the WWC method had "caused friction with U.S. trading partners and led to retaliatory legislation passed by the United Kingdom".[165] In addition, the court restated that the method discriminated against foreign commerce, calling the accounting requirements for the tax an "administrative nightmare".[166] California again appealed the decision to the California State Supreme Court.

In May 1992, the California Supreme Court justices unanimously reversed the California Third District Court of Appeal's decision, stating that only the U.S. Congress holds the power to regulate foreign commerce, and Congress had never passed legislation banning state use of the WWC method: therefore, the method was a legally valid method

of state taxation. This decision held that the lower courts had been incorrect in their interpretation of the dormant commerce clause theory. The U.S. Supreme Court's 1986 decision in *Wardair Canada, Inc.* v. *Florida Department of Revenue* had weakened the judiciary's ability to act under this clause, since it held that the courts should be more sensitive to issues of congressional intent, above and beyond concrete congressional action.

The California Supreme Court's analysis of congressional intent rested on three types of international agreements approved by Congress: bilateral tax treaties, Friendship, Commerce and Navigation treaties, and the 1979 U.S./UK income tax treaty. None of these banned the use of formulary apportionment by U.S. subfederal governments. California Supreme Court Justice Armand Arabian stated the law "does not give executive officials carte blanche to declare state tax methods null when they irritate our trading partners".[167] However, the high court ordered further proceedings before a state appeals court on the issue of whether the state's demands for financial data under the WWC method were overly burdensome, thus violating Barclays' right to due process.

Barclays then petitioned the U.S. Supreme Court for review of the case, which was denied on the basis that the company had failed to exhaust the available state remedies. The California Court of Appeal decided, on remand, that although the burden of supplying information was greater for foreign companies, it was not discriminatory, but only part of the greater administrative cost for a company doing business in a foreign country; thus, it did not violate the due process clause. The Supreme Court of California declined further review of the case, and Barclays again appealed to the U.S. Supreme Court for review.

By this time, the Barclays case had become a rallying point over whether California had the right to use unitary taxation in any form. The UK Financial Secretary to the Treasury stated that the best means of eliminating the WWC method in the U.S. was for governments to lend strong and active support to companies litigating in U.S. courts against state use of the method. Britain, backed by the EU, felt that allowing unitary

taxation to stand in California in any form posed a challenge to bilateral tax agreements founded on the arm's length standard, and might encourage other U.S. states, and even other countries, to use formulary apportionment methods.[168]

xxv) Alcan/ICI

Alcan Aluminum of Canada and ICI of Britain, which both had subsidiaries in California, filed a joint suit against the California Franchise Tax Board in 1986 in the U.S. District Court in Chicago, Seventh Circuit, opposing the unitary tax method on the grounds that it subjected them to double taxation by assessing a state tax on income from their operations outside of the U.S. In March 1986, the Reagan administration's Justice Department filed a brief in support of these companies, contending that unitary taxation interfered with the federal government's "exclusive power" to conduct foreign relations and regulate foreign commerce, since the tax method had become a source of conflict with foreign countries. This brief mentioned that the ambassadors of fourteen foreign countries had sent a diplomatic note stating that the unitary method was "a serious obstacle to further development of trade and investment relationships",[169] and added that "it is the clearly expressed policy of the United States that the separate accounting, or arm's length method, is the appropriate method of allocating income among commonly controlled multinational corporations".[170]

Foreign-parent MNEs had tried several times to file suits challenging U.S. state use of the WWC method on the grounds that the method violated the Foreign Commerce Clause of the U.S. Constitution. However, the courts consistently dismissed their arguments on the procedural grounds that foreign parent corporations could not present arguments because they were not technically 'the taxpayer' mentioned under the laws: only the foreign parent's domestic subsidiary could file suits in U.S. courts, as had occurred in the Barclays case. These rulings came despite parent companies' protests that their U.S. companies could not invoke the treaty provisions which are "at the heart of the claim that unitary tax impairs the conduct of foreign relations".[171] However, the Seventh Circuit Court in Chicago agreed to hear the Alcan/ICI case, holding that the foreign parent companies did have the standing to challenge California's method.

Canada, the UK, the EC, Japan and Australia all filed amicus curiae (friend of the court) briefs supporting Alcan's case against the California Franchise Tax Board. The Circuit Court decision on standing was immediately appealed by the FTB to the U.S. Supreme Court, who dismissed the Alcan/ICI case in January 1990 on the grounds that the case should not be heard at the federal court level before it had been fully aired in the state courts.

As directed by the U.S. Supreme Court, Alcan and ICI refiled their case in California. However, the California Superior Court ruled against Alcan and ICI on May 31, 1991, holding that worldwide combined reporting was constitutional. "On December 7, 1992, following the California court's November opinion in Barclays Bank, the court of appeals in Alcan Aluminium affirmed a lower court decision upholding California's use of the worldwide unitary method of taxation".[172] Appeals of the case then stalled pending the resolution of the U.S. Supreme Court's ruling in the Barclays/Colgate case.

xxvi) Colgate-Palmolive

In April 1984, Colgate-Palmolive had filed suit with the California State Court seeking a refund of the taxes it had paid California under the WWC method from 1970-1973. Colgate challenged the tax method on the grounds that the Foreign Commerce Clause of the U.S. Constitution effectively precluded California from forcing companies to report their worldwide income to the state.[173] As the Barclays case gained momentum, Colgate also began to argue that it would be discriminatory to continue applying the WWC method to domestic MNEs if it could not legally be applied to foreign-based MNEs. The California Superior Court in Sacramento County found in favour of Colgate in April 1989. This decision went against the 1983 Container case, where the U.S. Supreme Court had upheld California's right to apply the WWC method to U.S. parent companies. But by 1989, after the federal Working Group on Worldwide Unitary Taxation and the introduction of several pieces of legislation in Congress banning state use of the WWC method, there seemed to be more examples of federal opposition to the WWC method which had not been present at the time of the Container case.

However, federal support for U.S. companies opposed to the WWC method was not as strong as for foreign companies.[174] Although both the Reagan and Bush administrations had filed amicus briefs in support of Barclays at all levels of its court case, neither the Reagan or Bush administration filed amicus briefs in support of Colgate at any stage. Instead, Colgate's claim of federal support relied on informal statements made by the Reagan administration condemning the Container Corp. decision to assert that the WWC method placed an undue burden on U.S. foreign commerce. During appeal of the California Superior Court ruling against Colgate, the U.S. Justice Department under President Bush submitted letters in Colgate's defense which cited only cases of unfair unitary taxation involving foreign-based companies. The Third District Court of Appeal in Sacramento interpreted this to signify that the Bush administration was concerned only with the impact of the WWC method on foreign-based MNEs, particularly since it came in addition to the fact that the U.S. Justice Department had filed an amicus brief with the same court in support of Barclays. The Appeals Court re-applied the Container Corp. ruling against Colgate-Palmolive in August 1991.

Despite weak official support from the federal government on unitary reform for U.S. MNEs, a 1991 letter from the U.S. Treasury Secretary to the head of Colgate-Palmolive declared that "As a tax policy matter, we are equally opposed to the use of worldwide unitary apportionment to determine the income of domestic-parent. multinational corporations and that of foreign-parent multinational corporations".[175] In June 1992, the California State Supreme Court ordered the appeals court to reconsider its opinion in the Colgate case in view of the court's decision in favour of California in the continuing Barclays case.[176]

In November of 1992, the California Supreme Court found that in both the Barclays and Colgate case, the WWC unitary method of taxation was constitutionally valid, and ruled in favour of California on the grounds that Congress had consented to state use of the WWC method through its failure to pass legislation banning the

method.[177] The California Supreme Court declined to further review the case, and Colgate petitioned the U.S. Supreme Court for review.[178]

xxvii) The Bush administration

The Bush administration of 1988-1992 did not attempt to introduce federal legislation banning state use of the WWC method, but it actively supported foreign companies challenging the method in court cases. This administration was seen as less conflicted over the WWC issue than the Reagan administration had been, since there was not a strong push for fiscal federalism under the Bush administration.[179] On December 16, 1991, a report on unitary taxation jointly produced by the UK Inland Revenue and the U.S. Treasury reiterated the two governments' commitment to the elimination of worldwide combined unitary methods.

At an April 1992 hearing of the Barclays Bank case before the California Supreme Court, a U.S. Justice Department lawyer testified that the federal government was concerned the case could have a grave impact on foreign relations, and papers filed in the case by the Bush Administration called the tax system "an egregious interference with the federal executive's conduct of foreign affairs".[180] In March 1992, Brad Sherman, the Democratic chairman of California's State Board of Equalization, urged the federal administration to withdraw its support for MNEs in the unitary tax debate or risk having the unitary issue used against Bush in the 1992 presidential campaign as an example of tax avoidance by big business.[181]

In August 1992, the Department of Justice under President Bush filed a brief with the U.S. Supreme Court, urging it to hear the Barclays case on appeal and attacking state use of the WWC method, saying it "has created an irritant in the commercial relations of the United States and its major trading partners",[182] and "prevents the United States from speaking with one voice on this sensitive and important matter of foreign commercial relations".[183] The U.S. Supreme Court agreed to hear the Barclays case.

xxviii) The Clinton administration

During his 1992 presidential campaign, Bill Clinton promised to support California in the unitary tax debate.[184] Clinton needed California's electoral votes to win the 1992 presidential election; in addition, the Democrats were generally less ideologically bound to free-trade and business interests than the Republicans.[185] In June 1992, Clinton wrote a letter to Brad Sherman, the chairman of California's State Board of Equalization, stating "I assure you a Clinton administration will be pro-California in this litigation".[186] Sherman would use this letter to pressure Clinton after his election.

During his election campaign, Clinton alarmed foreign companies with claims that they were unfairly dodging their U.S. tax burdens and promises his administration would raise an additional $45 billion in taxes from foreign MNEs operating in the U.S.[187] There had been several out-of-court settlements by Japanese companies in the 1990s over alleged transfer pricing violations, and the American political atmosphere was fearful of increasingly successful Japanese economic competition.[188] This led to a general feeling in the U.S. that foreign companies were not being good corporate citizens,[189] which fed into Clinton's populist campaigning style. He supported state use of the WWC method as a means to prevent tax avoidance by foreign companies.[190] As a further hint of how the new administration was leaning, Lawrence Summers, Clinton's Undersecretary of International Affairs in the Treasury Department, reiterated his theoretical support for international formula apportionment during his U.S. Senate confirmation hearing in March 1993.

However, Clinton came under intense pressure from both foreign trade partners and MNEs to break his promise to Brad Sherman after he took office.[191] The National Association of Manufacturers (NAM), the Tax Executives Institute (TEI), and Black and Decker Corporation sent letters urging the Clinton administration to support Barclays in its U.S. Supreme Court case. The TEI letter said that the administration's decision would affect the government's ability to speak uniformly when implementing international commercial policy. The NAM letter noted that the executive branch had appeared as amicus curiae in all three levels of the California court system in the Barclays case, and

urged the Clinton administration not to change this position now. Black and Decker's letter argued directly that California's use of the WWC method offended foreign trading partners, and that affirmation of California's right to use the method would likely spark foreign retaliation against U.S. business abroad.

Torn by competing interests, Clinton tried not to take an official position on the Barclays Bank case. In 1992, the new Clinton administration urged the U.S. Supreme Court not to hear the case, hoping instead to work out a political compromise that would satisfy both sides. However, the president's initial neutrality was seen as supporting California, since it appeared to demonstrate that his administration was not unduly worried over its ability to conduct foreign relations.

xxix) Accelerated threats of UK retaliation

The Clinton administration's neutral stance on the Barclays/Colgate case against California provoked an intense lobbying campaign by the British government and business interests, which had pinned a great deal of hope on the lawsuit and were now convinced that the administration's neutrality would precipitate a court ruling in favour of California.[192] UK Prime Minister John Major was under mounting pressure from both backbench Ministers of Parliament and UK business leaders to take a tougher line with the U.S.: critics of his government argued that the U.S. had stopped believing the UK's continued threats of retaliation. The UK government announced on May 13, 1993 that it planned to activate Parliament's retaliatory tax legislation unless there was a solution found to the unitary tax problem by the end of 1993. After the announcement, UK Inland Revenue sent letters to over 900 U.S. companies with headquarters or operations in California, warning that they would lose their right to Advanced Corporation Tax credits on dividends paid by UK subsidiaries to their parent companies, a right granted under the U.S./UK tax treaty, if California did not change its law. It was estimated that revocation of the ACT credits could cost U.S.-based MNEs more than $1 billion.[193]

The threat of UK retaliation against U.S. MNEs operating in the UK helped spur these companies to increase their lobbying efforts before the California state government.

The threat of retaliation was seen as a "huge factor" in moving the unitary reform issue before the California legislature again, since many U.S. MNEs were more concerned with avoiding a retaliatory tax war than avoiding state imposition of the WWC method. [194]

Suspicions lingered, however, that the British were not serious about their threatened retaliation: the stakes were too high.[195] Many speculated that if the UK did retaliate, the U.S. Congress would see such an action as overriding the existing U.S.-UK tax treaty and retaliate against the UK. California State Senator Leroy Greene introduced a California Senate 'Joint Resolution' in early September 1993 requesting that if the UK government retaliated against California's unitary method, the U.S. President impose Section 891 of the U.S. Internal Revenue Code on companies headquartered in the UK, which would double U.S. tax rates on British citizens and corporations.[196]

xxx) Foreign pressures mount

The European Commission joined the European Parliament in warning that if California continue to use the WWC method it would lead the European Union (EU) to suspend double taxation treaties with the U.S. EU Tax Commissioner Scrivener stated in early 1993 that the re-introduction of mandatory WWC unitary taxation in any U.S. state might force the EU to retaliate against American companies.[197] On June 30, 1993, the Finance Committee of the German Bundestag asked the German government to consider retaliation if the unitary issue was not resolved quickly. The Japanese had also continued lobbying on the issue, although they were not as concerned with the tax method at this point.[198]

xxxi) Build-up to reform in 1993

Renewed UK threats of retaliation and continued threats of withdrawn investment by MNEs opposed to California's use of the WWC method held more force now than they had during the 1986 unitary reform debate, since the state's economy had weakened considerably by the early 1990s. California experienced a series of natural disasters in the early 1990s, foreign investment in the state began to slow, and a national economic recession took hold.[199]

MNE threats to leave the state over the WWC method were an important stimulus towards converting the California legislature to believe that the tax was harming the state's economy simply by contributing to the perception that California was not friendly to business.[200] The same legislation included measures which California's high-tech companies had been lobbying for: a 6% investment tax credit for the purchase of manufacturing equipment, a 5% sales tax exemption for new companies, and a permanent research and development tax credit. This added to the view that reform of the unitary law in 1993 was part of a more general effort to improve the state's business climate.

Increasingly, California began to feel that it was in competition with other states for investment.[201] In the early 1990s, 34 states and cities had located full-time staff in California seeking to attract businesses away from the state.[202] Between 1987 and 1992, an estimated 708 manufacturing plants either left California or expanded elsewhere.[203] In 1984, Oregon was one of the first U.S. states to repeal its WWC method, and a member of a Portland Development Commission task force stated that "the repeal was critical in attracting new Japanese investment. You can't underestimate the importance of intangibles, and a state's attitude toward business is one of the most important factors".[204] Washington state, which never imposed a WWC tax method, succeeded in attracting Kyocera Northwest Inc., SEH America, and American Kotobuki Electronic Industries to its state after all had considered settling in California.[205] Arizona, another state without a WWC unitary method, had also seen the relocation of several businesses previously based in California.

California's weakened economy prompted the state legislature to attempt to change California's image as a high-tax, overregulated market and to reverse the outflow of capital taking place to neighbouring states.[206] At the same time, California's shift from a manufacturing economy, with the downsizing of aerospace and defense industries at the end of the Cold War, to a service economy, with a newly developing high-tech industry, pushed the state legislature to assist the business community during a period of structural change.[207]

In the early 1990s, there was a bipartisan effort by the California legislature to pass pro-business legislation.[208] By 1993, California politicians had formed economic development committees which were touring the state to try to find ways to improve the state's economy. In this environment, legislation to modify the WWC method was seen as part of an effort to promote the state's willingness to provide a favourable business climate.[209] At the very least, in a downturned economy, California politicians did not wish to be publicly blamed for anything which could be portrayed as hurting state business.[210]

At the same time, a series of state budget crises in the early 1990s repeatedly brought California to the brink of bankruptcy. While most observers expected California to win the Barclays case before the U.S. Supreme Court, the possibility was always present that the state might lose.[211] An unfavourable court ruling would mean California would lose a revenue stream already included in projected state budgets and might be forced to pay back taxes already collected under the WWC method. California, along with several other states which submitted amicus briefs to the U.S. Supreme Court, argued explicitly that the revenue loss alone from a Barclays victory would be too damaging to the state's economy to countenance. California then filed a separate amicus brief with the Supreme Court asking that, in the event of a ruling against the state, California not be forced to pay back taxes it had collected under the WWC method due to the state's precarious fiscal position.

xxxii) 1993 California legislation

Driven by its downturned economy, the threat of British retaliation against MNEs doing business in California, intensified lobbying efforts from U.S. MNEs worried over UK threats of retaliation, and the pending U.S. Supreme Court verdict, California policymakers began to debate Senate Bill 671, again authored by Senator Alquist, to reform the state's unitary tax method. Many of the same lobbyists and California bureaucrats which had been present in 1986 were involved in the 1993 legislative debate. However, the general consensus in California remains that 1986 was the year when the issue of unitary reform was really decided, and the 1993 legislation was simply a

modification of the 1986 law.[212] Many of the most active groups who had lobbied on the unitary issue in California in the 1980s, such as the California Business Council and the Organisation for the Fair Treatment of International Investment, disbanded after the 1986 legislation and did not regroup for the 1993 legislative debate.

However, the California Chamber of Commerce, the California Manufacturers' Association, and the California Taxpayers' Association put together a task force of technical experts from both U.S. and foreign-domiciled companies to review the California reform bill. U.S. companies were eager to address what they viewed as continued restrictions on a water's edge election, including the requirement that companies file a domestic spreadsheet listing all of their U.S. business activities, the FTB's option to disregard a water's edge election, and the election fee. By eliminating some of the restrictions on a water's edge election, SB671 was designed to make electing companies feel less like "second class citizens".[213]

The issue of equity between foreign and domestic companies was not as great in 1993 as it had been in 1986.[214] Although most California legislative staff saw foreign governments and MNEs as the primary drivers of the 1993 legislation, reform of the state's tax method was viewed as a 'big business' issue which affected both foreign and domestic MNEs equally.[215] The California Manufacturers Association argued SB671 was important because it would remove the threat of British retaliation against U.S. MNEs while helping California's position in the *Barclays Bank* v. *Franchise Tax Board* case, which represented a potential loss of $4 billion in state revenues.[216] Although most of the state's top business groups supported the bill, California Governor Pete Wilson did not take a position on SB671. Opposition to the bill came from local groups arguing further unitary reform was a tax break for big businesses which came at the expense of funding for social issues during an economic recession.

California's unitary reform legislation of 1993 eliminated the domestic disclosure spreadsheet requirement, requiring instead that companies which had at least $1 billion in U.S. assets submit a list of any 20% or more-controlled affiliates in other states with their

tax returns. In addition, the election period was shortened from ten to seven years, with automatic annual renewal unless the taxpayer notified non-renewal, and the sales factor in the apportionment formula was double-weighted. This was considered a pro-business investment provision, since it primarily hurt companies that sold into California without investing in the state.[217]

However, since the state was suffering fiscally, U.S. companies did not receive rectification of their long-standing complaint that 80/20 companies should not be included in the water's edge definition, since this would have cost the state a great deal in lost revenue; it was estimated that eliminating the election fee alone would cost the state an estimated $45-100 million in lost revenue.[218]

President Clinton had given the impression that he would not file an amicus brief supporting California in the Barclays case before the Supreme Court unless the state first changed its unitary method to mollify the method's protesters, and a favourable amicus brief was seen as crucial to California's case.[219] Arguments from Senator Alquist in support of SB671 stressed the "urgent need" to influence the U.S. Solicitor General's brief in the Supreme Court case and head off the threat of British retaliation.[220] The California legislature was concerned that, unless California's law was changed in a manner acceptable to the Clinton administration, the state would not receive a favourable brief from Clinton, and California would lose the Barclays case.

Representatives from the U.S. Treasury Department, along with concerned MNEs, met with a group of senior California tax committee staff to work on the state bill.[221] The Fiscal Policy Office of the California Senate Rules Committee was also in touch with the federal government. California legislators then faxed a copy of the pending 1993 unitary reform bill to President Clinton in order to ensure that the proposed changes were acceptable to the administration.

The UK government had threatened retaliation against U.S. MNEs if California's unitary tax law was not changed by the end of 1993. According to California's

constitution, passed bills go into effect as law on the January 1st following a 90-day period from their enactment.[222] If California's unitary change was to be enacted in time to meet the UK government's deadline, the bill had to be passed on September 10, 1993. After a vote on September 11, 1993, SB671 was passed, and just made the deadline. The new law removed both the election fee and the Franchise Tax Board's right to override a company's election of a water's edge assessment, a right it had never used; instead, companies that failed to provide enough information to the FTB would be subject to substantial fines. What remained unchanged was that corporations incorporated in the U.S. and more than 50 percent owned or controlled, directly or indirectly, by the same interests were considered unitary businesses, far less than the 80 percent common ownership required to file federal consolidated income tax returns. Moreover, California maintained its right to use the WWC method. The bill went into effect on January 1, 1994.

California's 1993 unitary reform was included in a bipartisan package of more general economic improvement legislation.[223] The press release issued by California Governor Wilson announcing the passage of SB671 was entitled "Wilson Signs Landmark Legislation to Spur California Jobs", and Wilson stated that "These tax reforms are the centerpiece of an economic growth agenda", enabling California to compete for new investment with other states.[224]

Revenue loss was ultimately not an issue in the 1993 legislation, since the final reform bill contained provisions that raised an additional $140-150 million in annual state tax revenue by limiting deductions for business entertaining and private club dues to conform with changes in the U.S. federal tax code. These changes offset losses from modifications in the WWC method and made the final state reform law revenue-neutral.

There were lingering complaints over the new legislation. U.S. MNEs remained concerned that the playing field between foreign and domestic companies was not level, since the foreign dividends of U.S. companies were still partially taxed by California

while dividends received by the subsidiaries of foreign-domiciled companies operating in California were not.[225]

Although the British would have preferred a mandatory water's edge combination, the UK Chancellor of the Exchequer stated on September 15, 1993 that the UK would defer retaliation. However, he said the British government would keep its retaliatory legislation in reserve in case mandatory use of the WWC method was reintroduced in the future by California or any other state.[226] Moreover, the UK government repeated that it remained fully committed to supporting Barclays' case before the U.S. Supreme Court, since a successful resolution of this case would permanently end state use of the WWC method and establish the arm's length standard as the only valid method of taxing foreign companies in the U.S.

xxxiii) The Barclays case goes forward

After Governor Pete Wilson signed California's unitary reform legislation into law on October 6, 1993, the Clinton administration filed an amicus brief on October 7, 1993 which asked the U.S. Supreme Court to drop the Barclays case, arguing the legislation meant the state now sufficiently conformed to the federal and international arm's length standard.[227] However, Barclays pressed on, arguing that the state's new law still held to the principle that California had the right to use the WWC method and did not resolve the issue of whether the state owed Barclays a refund of taxes previously paid under the WWC system.[228]

The UK government supported the continuation of Barclays' case in a desire to see state use of the WWC method ruled illegal once and for all and out of fear that other U.S. states would be encouraged to adopt the method if the U.S. Supreme Court did not definitively rule against California.[229] Foreign governments also appeared concerned that Clinton's request that the court drop the Barclays case, along with Clinton's pre-election support for California's use of the WWC method, meant the U.S. federal government was weakening in its support of the arm's length standard.[230]

On October 14, 1993, EC member countries joined with Australia, Austria, Canada, Finland, Japan, Norway, Sweden and Switzerland to file an amicus brief with the U.S. Supreme Court stating that they did not consider California's legislation to have solved the unitary debate, since a conclusive solution would establish the arm's length principle as the only legitimate basis for taxing foreign companies in any U.S. state.[231] Additional amicus curiae briefs were filed with the Supreme Court in support of Barclays Bank by the Keidanren, Banque Nationale de Paris, Nestlé, the Confederation of British Industries, Reuters, the Japan Tax Association, the Federation of German Industries, and the Association of German Chambers of Industry and Commerce. The principal foreign country criticisms of combined reporting were that it imposed a large administrative burden, led inevitably to extra-territorial and double taxation, was contrary to standard international practice, might encourage the use of the method by developing countries, and discouraged foreign investment in the U.S., since any state might adopt the method if it was not ruled illegal by U.S. courts.[232] Briefs were filed with the court in support of California by the Committee on State Taxation, the Council of State Governments, and Citizens for Tax Justice.

Despite the Clinton administration's request that the Supreme Court dismiss the Barclays case, in November 1993, the court decided to continue with its review of the case, and to join it with a review of the pending Colgate-Palmolive case to decide the issue of U.S. state use of the WWC method once and for all. The U.S. Supreme Court then pressed the Clinton administration to formally file a brief stating its opinion on state use of the WWC method in order to help the court determine if the federal government viewed California's law as harming its ability to conduct foreign policy.

Foreign lobbying associations were clearly upset by the Supreme Court's joining of the two cases: since U.S.-domiciled companies had a weaker legal case, given that the Supreme Court had already ruled in the Container Corp. case that states could apply the WWC method to U.S. MNEs, it now seemed there was a much lesser chance of victory for foreign companies.[233]

In addition, foreign companies were upset that the court had joined the Barclays and Colgate cases because, although secondary arguments were made by Barclays under the supremacy and due process clauses of the U.S. Constitution, the main argument used by both Barclays and Colgate was that state use of the WWC method violated the Commerce Clause of the U.S. Constitution, and thus seriously interfered with the federal government's ability to conduct foreign relations. This argument more strongly favoured foreign companies alone, since the 1979 Japan Line case had created two additional tests for foreign companies to ensure that state tax schemes complied with the commerce clause by not burdening international commerce. At this point, most legal commentators felt that Barclays and Colgate would lose their case.[234]

The California FTB's argument before the Supreme Court followed the reasoning from the U.S. Supreme Court's 1986 decision in *Wardair Canada, Inc.* v. *Florida Department of Revenue*[235] by stating that the U.S. Senate's 1979 refusal to ratify the U.S./UK tax treaty containing a provision (Article 9(4)) barring state use of the WWC method meant that Congress agreed with California's use of the method. The State of California argued that only violations of treaties violated the U.S. Constitution's foreign commerce clause, and state use of the WWC method had not been outlawed by any treaty. Although the federal government had endorsed the use of the ALS, unitary methods were not necessarily completely incompatible with ALS, since the federal government itself employed portions of both methods by using the profit splitting and comparable profit interval methods alongside the ALS. The COST organisation's amicus brief argued that MNEs were attempting to make a default foreign policy with the Supreme Court case, bypassing Congress, which had not acted through either treaty or federal law to ban state use of the WWC method. It was not the place of the court to decide foreign policy, they argued, but Congress.

xxxiv) U.S. Solicitor General Brief

When pressed by the U.S. Supreme Court to take a stance in the Barclays/Colgate case, Clinton decided to officially support California. His decision reflected his "intense political interest" in the state and concerns over California's economy, battered by a

national economic recession and steep cuts in federal defense funding.[236] The state faced an estimated $10.7 billion budget deficit in 1993, which would be substantially worsened if the Supreme Court ruled against the state.[237]

U.S. Solicitor General Drew Days filed an amicus curiae brief on January 19, 1994 arguing against both Barclays' and Colgate's claims. Days claimed that the Bush and Reagan administrations' previous briefs were flawed in focusing too much on the government's present position that state use of the WWC method was unconstitutional. He argued that the court need focus only on what the government's position had been at the time the state taxes were imposed on the companies. Since it was not until the mid-1980s that the federal government strongly express the view that state use of the WWC method was unconstitutional, Days stated that at the time the taxes under dispute were collected, the U.S. government had expressed "a preference and not a policy".[238] Therefore, California's assessment against Barclays in 1977 and against Colgate-Palmolive in 1970-73 were constitutional. The Solicitor General brief was seen as quite weak in its support of Barclays and Colgate, since it refused to take a principled stance on state use of the WWC method, and most observers viewed the brief as a political solution which tried to avoid offending both California and the UK.

The Clinton administration's Solicitor General brief was seen as having an important bearing on the outcome of the case since the Supreme Court had specifically demanded that the administration take a position on the case, and the positions of U.S. administrations had been cited in several previous court decisions, including the Container Corp. and earlier Colgate cases, as important in determining whether the federal government's ability to "speak with one voice" had actually been impaired. Administration officials sought to cushion the federal government's changed stance in the Barclays case by stating they would work with foreign governments to resolve disputes about California's current law. However, FTB Board Member Brad Sherman said the administration's new stance "took all the steam and momentum out of Barclays' position".[239]

In retrospect it seems that the Clinton administration's weak brief had less impact on the Supreme Court decision than expected. The Supreme Court's final decision in the case was based on arguments over the constitutional separation of powers, and did not mention the foreign commerce clause, which most legal commentators at the time had felt would be the deciding factor in the case. Ironically, the one consistent argument between the amicus briefs of the Clinton and Bush administration in the Barclays' case was a rejection of California's argument that Congress, since it was undoubtedly aware of the controversy, was in agreement with California's tax policy simply because it had failed to pass legislation prohibiting the state's use of the WWC method. In fact, this was precisely the Supreme Court's reasoning in the case.

xxxv) Barclays/Colgate ruling

The U.S. Supreme Court ruled in favour of California on June 20, 1994. Justice Ruth Bader Ginsburg wrote in the decision that: "We leave it to Congress - whose voice, in this area, is the nation's - to evaluate whether the national interest is best served by tax uniformity, or state autonomy. This court has no constitutional authority to make the policy judgments essential to regulating foreign commerce and conducting foreign affairs".[240] The court added that since double taxation was not the inevitable result of worldwide combined reporting and since no other method could be guaranteed to alleviate this risk, the WWC method was as good a method as any. While they agreed the WWC method might violate the due process clause by posing unduly onerous compliance requirements on foreign companies, they ruled that in this case, Barclays had exaggerated its compliance costs. In addition, foreign companies had to expect that doing business in foreign countries would engender additional costs. Since this ruling, there has been no further action to modify California's unitary tax method.

3) Summary

This chapter has presented a descriptive case study of the debate over California's use of the worldwide combined unitary tax method as an example of state-firm bargaining over a subfederal economic regulation which conflicted with federal and international

norms. The presentation of this case study adds to the body of academic literature on both state-firm bargaining and on subfederal activity in the international arena. It also provides further evidence towards the hypotheses presented in Chapter One that powerful U.S. states such as California possess the capability to both maintain regulatory standards at odds with federal and international norms and to bargain directly in the international arena.

As we have seen from the case study, California was able to maintain a regulatory standard at odds with federal and international tax norms. The federal government, international organisations, foreign governments, and multinational enterprises, both foreign and domestic, which protested California's tax method were unable to quickly force the state into line. Further, the U.S. federal government did not simply take over negotiations following protests against the state's violation of international norms: California was able to use its political and economic assets, outlined in Chapter Four, and resources under the U.S. federalist system, detailed in Chapter Three, to bargain directly with international actors. The following chapter will analyse this case study to complete the model of state-firm bargaining over subfederal economic policies which conflict with international norms, and to determine the strategies which actors can use to effectively influence such policies.[241]

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[1] Stopford and Strange, 1991, p. 236.
[2] Weiner, 1994, p. 161.
[3] 17 Cal 2d 664, 678, 315 U.S. 501.
[4] Further, *Edison California Stores, Inc.* v. *McColgan, supra* (1947, 358 U.S. 459) established that a business was considered unitary when the operation of its business within California contributed to or was dependent upon the operation of its business outside the state. These principles were reaffirmed in *Superior Oil Co.* v. *Franchise Tax Board* (1963) and *Honolulu Oil Corp.* v. *Franchise Tax Board* (1963). The Appeal of F.W. Woolworth Co. to the California State Board of Equalization on July 31, 1972 confirmed that the existence of a unitary business could be established if either the three unities or the contribution or dependency test was satisfied.

In 1959, in the *Northwestern Portland Cement* and *Stockham Valves* cases, the U.S. Supreme Court ruled that regular and substantial solicitation of sales within a state made a corporation liable for a fairly apportioned state income tax, even if all of its transactions were in interstate commerce. Congress immediately responded to business protests by enacting PL 86-272 on September 15, 1959. This law provided an income tax exemption if a corporation's only activity in a state was to solicit sales, while sale orders were filled out-of-state. PL 86-272 remains the only law passed by the federal government which significantly limits state powers to tax corporate income. (Weiner, 1994, p. 150).

[5] This report was issued in September 1965.

[6] S1688 was introduced by Senator Mathias, and House of Representatives (HR) bill 5076 was introduced by Representative Conable: these bills were collectively known as the State Foreign Source Income Tax Bill.

[7] Weiner, 1994, p. 179.

[8] 1981 saw bills introduced by Conable (HR 1983) and Mathias (S 655) in the 97th Congress, and a 1983 bill introduced by Mathias (S 1225) in the 98th Congress. The Multistate Tax Commission estimated the original Conable/Mathias bills (HR 1983 and S 655) would have cost 33 U.S. states over $700 million in 1983, and these bills were never acted on.

[9] Farr, 1985.

[10] Ibid.

[11] September 26, 1980.

[12] June 20, 1983.

[13] June 21, 1983.

[14] SB 1225 was introduced by introduced by Senator Mathias.

[15] Farr, p. 118.

[16] The Council of the Netherlands Federation of Employers VNO and NCW, 1981, p. 107.

[17] Qureshi, 1987, p. 61.

[18] Koning, 1984, p. 295.

[19] March 19, 1980; October 30, 1981; and August 1, 1983. A further representation was delivered to the U.S. State Department on September 23, 1983.

[20] European Communities, 1984.

[21] Interview #7.

[22] Ibid.

[23] Ibid.

[24] In its review of IRS data on 519 U.S. MNEs, the GAO found that only 3% of the IRS's recommended Section 482 adjustments to reported income were based on a true arm's length price: the remaining adjustments were based on estimated prices constructed by the IRS using complex guidelines prescribed by the Department of the Treasury, which caused administrative burdens and uncertainty for both the IRS and taxpayers.

[25] GAO/GGD-82-38, 1 July 1982.

[26] The report stated that unitary taxation imposed additional administrative burdens on foreign corporations, as opposed to domestic-domiciled MNEs, from the need to: 1) translate foreign currencies; 2) adjust foreign financial statements to meet state income tax reporting requirements; and 3) determine what is included in the unitary business.

[27] California Assembly Revenue and Taxation Committee, November 7, 1980, second citation.
[28] The bill was amended on May 22, 1980.
[29] Interview #28.
[30] Ibid.
[31] Interview #28.
[32] Ibid.
[33] Ibid.
[34] Interview #42.
[35] California Franchise Tax Board, 1981, p. 2.
[36] 226 U.S. 271 (1924).
[37] 445 U.S. 425 (1980).
[38] 65 Law Ed. 2d 66.
[39] 441 U.S. 434 (1979).
[40] 441 U.S. at 446.
[41] 441 U.S. at 448.
[42] Interview #7.
[43] Brief of the Government of the United Kingdom in the Barclays/Colgate case, 1993, p. 158.
[44] Tax Notes, August 1983, p. 348.
[45] Interview #50.
[46] This letter was sent by Marc Lalonde on August 11, 1983.
[47] On August 11, 1983.
[48] On August 17, 1983.
[49] Tax Notes, August 1983, p. 348.
[50] Tax Notes, September 1983, p. 26.
[51] On September 12, 1983.
[52] Sacramento Bee, 1983, p. A-13.
[53] Rothschild, 1984, p. 155.
[54] Brief of the California Legislature in the Barclays/Colgate case, 1994.
[55] Tax Notes, Nov. 7, 1983, p. 525-526.
[56] The states' approach followed the Advisory Commission on Intergovernmental Relations' Report on State Taxation of April 1983 which (1) had formulated a test for federal intervention in state tax policies based on a stringent showing of "serious national harm", and (2) concluded that this criteria was not met by the effects of the unitary method (Advisory Commission on Intergovernmental Relations, 1983).
[57] Tax Notes, November 28, 1983, p. 821.
[58] Transcript, Second Meeting of the Working Group on Worldwide Unitary Taxation, p. 36-37, lines 22-5.
[59] Options 2 and 3 were identified as state options, options 4 and 5 as business options, and option six as the Advisory Commission on Intergovernmental Relations compromise option. Option 2 allowed U.S. corporations to be assessed under the water's edge method, along with both 80/20 corporations and dividends by U.S. companies received from their foreign subsidiaries. Option 3 offered only a slight variation on Option 2's treatment of dividends. Option 4 excluded 80/20 companies, provided a 100% exemption for

dividends received from more than 80% U.S.-owned corporations, and an 85% exemption for all other dividends, making no distinction between foreign and domestic corporations. Option 5 differed only from Option 4 in excluding most foreign-sourced dividends through a complex formula.

[60] Transcript, Second Meeting of the Working Group on Worldwide Unitary Taxation, p. 28-31.

[61] Carson and Kreisher, 1986. p. A-1.

[62] Inside U.S. Trade, 1984, p. 14.

[63] Regan, 1984.

[64] Rothschild, 1986, p. 375.

[65] 393 Mass. 490 [12/11/84], 472 N.E.2d 259.

[66] See Appendix 2 for a time-line of U.S. state repeal of the WWC method.

[67] This power came from Section 54 of the 1985 UK Finance Act. According to the UK Budget, released in March 1985, "A qualifying presence exists when the principal place of business...is in a unitary state, or when it is subject to tax in a unitary state, or when 7.5 percent or more of its assets or sales is derived from a unitary state" (World Tax Report, August 27, 1993, first citation). It was estimated the denial of ACT tax refunds would raise the effective tax rate of U.S. subsidiaries in the UK from 28 percent to 33 percent, and cost American companies $3.76 billion.

[68] Interview #39. The U.S. Internal Revenue Code authorises the president to retaliate against foreign discriminatory taxation through Section 891: doubling the rates of tax on citizens and corporations of certain foreign countries, and Section 896: adjustment of tax on nationals, residents, and corporations of certain foreign countries (J. Dwight Evans, 1994, p. 26).

[69] This legislation was introduced in Congress on December 18, 1985 as S1974 by Sen. Pete Wilson (R-California) and as HR3980 by Rep. John J. Duncan (R-Tennessee).

[70] Interviews #3, 7.

[71] Forman, 1986.

[72] Interview #23.

[73] See Figure 16 from Chapter 4 for lead country investors in California during the 1980s.

[74] An audio equipment factory in Florida, a magnetic tape facility in Alabama, and a $40-million compact disk manufacturing facility in Indiana.

[75] The Oakland Tribune, 1985, p. B8.

[76] This including opening a new wafer fabrication plant in Washington state in November 1985.

[77] See Appendix 13 for a discussion of the division between domestic companies over mandatory vs. optional use of the WWC method.

[78] In 1982 and 1984.

[79] Kamuf, 1987, p. 6.

[80] Interview #23.

[81] Interview #35.

[82] Carson, August 4, 1986.

[83] Interview #25.

[84] Interview #10.

[85] Interview #25.

[86] Helmke, 1985.
[87] Ibid.
[88] Consulate General of Japan, 1985.
[89] Interview #25.
[90] Interview #42.
[91] Interview #32.
[92] See Appendix 11 for further description of the debate over foreign-sourced dividends for U.S. MNEs.
[93] Interview #42
[94] AB1300 was sponsored by Assemblyman Sam Farr, chairman of the Economic Development and New Technologies Committee, and a strong supporter of Alquist's plan.
[95] Interview #35. This bill was characterised as benefiting foreign companies since it excluded 80/20 companies and the foreign dividends of U.S. MNEs from the water's edge definition.
[96] Interview #34.
[97] Interview #30.
[98] Interview #42.
[99] $140 million in domestic relief and $60 million in foreign relief.
[100] $525 million in domestic relief, and $60 million in foreign relief. However, if AB2922 was amended to include the foreign dividends of U.S. companies in the water's edge definition, revenue loss would fall by $200 million (California Franchise Tax Board, June 5, 1986). In addition, it was estimated that inclusion of 80/20 companies in the water's edge option would cost the state $220-270 million (Doerr, August, 1985).
[101] Gunnison, August 19, 1985.
[102] Interview #25.
[103] Interviews #7, 10.
[104] Interview #3.
[105] "According to one study, the average corporate tax setback (of removing the unitary tax) has been 15 to 25 percent...(but) there have been no studies of the impact of new investment on water's edge states' economies" (Laird, 1987, p. 24).
[106] Interview #36.
[107] Ibid.
[108] Interview #32. The California Manufacturer's Association (CMA) formed The California Manufacturer's Research and Education Foundation to conduct a study on California Franchise Tax Board (FTB) estimates of revenue loss from unitary reform by accessing FTB records stripped of taxpayer names. They published a report, "Facts Behind the Figures: Water's-Edge vs. Worldwide Unitary Taxation", on March 28, 1985. This report criticised the FTB's Revenue Impact Study of May 1984, which had projected a loss of $560 million for California's fiscal year 1984-85 if WWC was changed to a mandatory water's edge assessment. The CMA study claimed that the projected revenue loss to California was overstated by as much as 50%. However, they merely criticised the FTB's methods and did not offer an alternative figure. The CMA claimed victory, stating that the purpose of their study was to get the FTB to admit that their numbers were not

"exactly right" (Interview #36). State opponents of unitary reform, however, continued to argue that the CMA numbers were not as complete as the FTB's.

[109] Interview #24.

[110] Interview #25.

[111] Ibid.

[112] Interview #39.

[113] Interview #24.

[114] Interview #3.

[115] Interview #25.

[116] Walters, August 1993.

[117] Brief of the Government of the United Kingdom in the Barclays/Colgate case, 1993.

[118] Brief of the California Legislature in the Barclays/Colgate case, 1994.

[119] Interview #28.

[120] Walters, 1985.

[121] Gunnison, August 19, 1985.

[122] In the end, the closure of two loopholes to conform California law with the anticipated 1986 Congressional tax reform bill, HR 3838, saved the state $111 million by changing the deductions for bad debts and altering the reporting of income from installment plan sales. In addition, the election fee helped balance the revenue loss.

[123] 80/20 corporations were giving the option of choosing to elect water's edge combination, although all of their foreign-sourced dividends would be included in a water's edge election, making this a financially untenable choice for most. The bill excluded activities in U.S. domestic possessions and territories, such as Puerto Rico, from inclusion in the water's edge. It required the IRS to expand its audit staff and budget to enter into information-sharing arrangements with the states.

[124] Weiner, 1994, p. 164.

[125] However, companies could lower the fee to a floor of 1% by increasing their property and payroll in California. It was estimated the election fee would raise $38 million annually, based on the assumption that two-thirds of foreign-domiciled MNEs would opt for a water's edge assessment and pay the election fee. This money would go into a fund supporting infrastructure development and the economic development programs of the California State World Trade Commission, the California Department of Food and Agriculture, and the California Small Business Bond Insurance Corporation.

[126] Alquist, August 1986.

[127] Ibid.

[128] United Press International, August 28, 1986, p. 33.

[129] Roach, August 27, 1986, p. A-3.

[130] United Press International, August 28, 1986, p. 33.

[131] Yoshihara, 1986.

[132] Ibid.

[133] Smith, 1993.

[134] John Ikeda, 1988, p. AA-1.

[135] Carson and Kreisher, 1986, p. A-1.

[136] Otten, 1986.

[137] See Appendix 12 for a further discussion of 80/20 companies.

[138] Shuit, August 27, 1986, Home p. 1.
[139] Roach, August 27, 1986, p. A-1.
[140] Carson, September 6, 1986.
[141] Hartsock, 1986, p. A-15.
[142] Gutfeld, 1986.
[143] Platt's Oilgram News, 1986,p. 3.
[144] Interview #36.
[145] Ibid.
[146] Interview #38.
[147] Interview #35.
[148] Interviews #35, 50.
[149] Interview #38.
[150] Interview #50.
[151] Brief of the Government of the United Kingdom in the Barclays/Colgate case, 1993.
[152] Interview #25.
[153] Skelton, January 16, 1987, Home p. 3.
[154] Ibid.
[155] The Orange County Register, 1987, p. 3.
[156] Ibid.
[157] Associated Press, April 9, 1987, p. A-3.
[158] Associated Press, April 15, 1987, p. A-6.
[159] The theory that foreign firms had lower U.S. tax payments due to transfer pricing manipulation was challenged by economists on four grounds:

1) foreign companies have greater start-up costs
2) foreign investments are newer, and firms have lower profits in their early years of operation
3) exchange rate fluctuations in the 1980s depressed U.S. earnings
4) foreign MNEs' taxable income measured as a percentage of their total assets is lower not because their tax payments were lower, but because their capital assets are newer, and worth more at book value (Tanzi, 1995).

[160] Whether the company's profits fell within this range would be determined by a complex six-step analysis. Moreover, the comparable profit interval method could be used by itself to determine the correct taxable income. The proposed regulations still listed comparable uncontrolled prices as a first priority for comparison in judging transfer prices, followed by the resale price, the cost-plus method, and other, unspecified 'fourth methods', presumably profit splitting. But the last three methods would now have to be validated by the comparable profit interval method (Muchlinski, 1995, p. 293).
[161] These regulations were widely criticised on the grounds that:

"1) Companies would be forced to disregard actual contractual terms agreed on commercial principles and apply artificial pricing rules based on hypothetical profits;
2) this would introduce arbitrary additional tax costs;
3) vast amounts of detailed information would have to be amassed about the confidential affairs of U.S. and foreign companies;
4) this information would often be unavailable and, as a result, the IRS would

have to make subjective judgments about profit comparisons;
5) international double taxation would be increased to an unprecedented scale." (Muchlinski, 1995, p. 294).

[162] Ibid.
[163] Ibid., p. 295.
[164] J. Dwight Evans, 1994, p. 19.
[165] Weiner, 1994, p. 168.
[166] Ibid., p. 168. Barclays estimated it would cost the company $6.4 to $7.7 million to establish an accounting system to calculate its WWC unitary tax, and another $2 to $3.8 million a year to maintain the system.
[167] Rice, 1993.
[168] Interview #50, #3.
[169] Associated Press, March 13, 1986.
[170] Benjamin Shore, March 13, 1986, first citation.
[171] The United Kingdom, April 1984, p. 157.
[172] Weiner, 1994, p. 174.
[173] Weiner, 1994, p. 170.
[174] Interview #42.
[175] September 13, 1991. Brief of petitioner, Colgate-Palmolive, on writ of certiorari to the Court of Appeal of the State of California, and for the Third Appellate District, 1993
[176] Weiner, 1994, p. 172.
[177] On remand, the Court of Appeals vacated its earlier decision and adopted the California Supreme Court's reasoning.
[178] J. Dwight Evans, 1994, p. 21.
[179] Interview #11.
[180] Egelko, May 1992.
[181] Los Angeles Times, 1992, p. A5.
[182] Walters, January 1994, p. A3.
[183] U.S. Amicus Brief, 1992, p. 12.
[184] Interview #11.
[185] Ibid.
[186] Rankine, 1994.
[187] Dickson, 1993.
[188] Interview #4.
[189] Ibid.
[190] Ibid.
[191] Interview #8.
[192] Interview #50.
[193] California Assembly Committee on Revenue and Taxation, 1993.
[194] Interview # 33.
[195] Interview #39.
[196] California Senate Committee on Revenue and Taxation, 1993.
[197] Reuters, 1993.
[198] Interview #32.
[199] Interview #1 and #3.

[200] Interview #26, #3, #8, #11 and #7.
[201] Interview #3.
[202] Fry, 1998, p. 119.
[203] Ibid.
[204] Laird, 1987. p. 24.
[205] David Dahl, 1987, p. 1B.
[206] Interviews #3 and #8.
[207] Interview #3.
[208] Interview #43.
[209] Interview #3.
[210] Interview #23.
[211] Interview #11. California estimated it would lose approximately $1.7 billion in tax refund payments and $2.3 billion in lost tax revenue from pending assessments. Interest on the $1.7 billion in tax refund claims, some of which went back to the 1970s, would substantially increase California's loss, and the state would lose any future revenues it might have collected under the WWC method, which had already been included in the state's projected budgets.
[212] Interview #34.
[213] Ibid.
[214] Interview #33.
[215] Interviews #18, 23. The original draft of SB671 required mandatory water's edge, but many companies who benefited from filing under the WWC method adamantly opposed this, and the legislation was changed to continue to allow an election. In fact, FTB Board Member Brad Sherman estimated the state would take in an extra $150 million a year if California had mandated use of the water's edge method, but lobbying from domestic MNEs succeeded in keeping the WWC method optional. The domestic pressure for an election surprised the UK government: they had assumed mandatory water's edge was the preferred option, and were afraid that allowing companies an election would hurt SB671's chances of passing, since it made the law more cumbersome and expensive (Miller & Chevalier, 1993).
[216] California Manufacturers Association, September 21, 1993.
[217] Interview #11.
[218] Griffing and Larson, 1993.
[219] Interviews #39, 32.
[220] Alquist, August 31, 1993, p.1.
[221] Interviews #23, 24.
[222] See p. 135 in Chapter Four.
[223] Interview #11.
[224] Bernstein, October 1993.
[225] See Appendix 12 for a further discussion of the debate over 80/20 companies.
[226] Interview #50.
[227] J. Dwight Evans, 1994, p.1.
[228] In addition, they argued, California's legislation included 80/20 companies in its definition of companies eligible to file within the water's edge, which did not conform to

the international standard of 'permanent establishment' rules in establishing water's edge eligibility.

[229] Interview #3.

[230] J. Dwight Evans, 1994, p. 27.

[231] Kraus, 1993.

[232] Brief for Petitioner in the 1993 Barclays case, p. 7.

[233] Interview #11.

[234] Interview #11.

[235] 477 U.S. 1

[236] Lauter, 1993.

[237] Sherman, 1992.

[238] Graham, March 29, 1994.

[239] Bernstein, 1994.

[240] Savage, 1994.

[241] Bernstein, October 1993.

Chapter 6: The Outcomes of the Debate

1) Introduction

Chapter Three defined the first three components of the model being built to evaluate state-firm bargaining at the subfederal level: the actors, their agendas, and their assets. This chapter will complete the model of state-firm bargaining over subfederal economic policies which conflict with international norms by i) evaluating how effectively the various actors used, or failed to use, their assets to achieve their policy agendas in the debate over California's unitary method; ii) evaluating how effectively the actors used various channels of negotiation to influence California's policy; and iii) determining the most effective uses of assets and channels of negotiation, key initiatives which influenced the outcome of the policy debate. Chapter Six will thus prove the key analytical chapter of the thesis.

This chapter will demonstrate that the actors' effectiveness in achieving their agendas during the California unitary tax debate was strongly determined by the political and economic assets they possessed and how effectively they deployed these resources. It will also support Hocking's view that negotiations over U.S. state economic policies are fluid and dynamic, and that actors must therefore use many different levers of influence when engaged at the U.S. subfederal level.

At the same time, Chapter Six supports the hypothesis put forth in Chapter One that U.S. states can bargain directly with foreign governments and multinational enterprises (MNEs) by describing the different channels of negotiation actors used to influence state policy during the debate over California's tax method. Further, it will demonstrate that California was able to effectively deploy its assets to delay a change in its regulation, adding support to the thesis' second hypothesis, that powerful U.S. states such as California can maintain regulatory standards at odds with federal and international norms.

Chapter Three defined the potential power, the political and economic assets, that each actor possessed upon entering into the debate over California's unitary tax method. How much of the actors' potential power was successfully translated through state-firm bargaining into influence over the outcome of the debate? According to Keohane and Nye, political bargaining converts power measured by type of resources into power measured by effects on outcomes.[1] This chapter will assess the successful strategies needed to turn an actor's potential power into influence over outcomes when bargaining over subfederal economic regulations which violate federal and international norms.

2) The use of assets

The assets that actors possess upon entering the bargaining process give them the potential to affect the outcomes of a policy debate. As defined in Chapter One, political assets are those which give an actor the ability to influence policy directly, and include resources such as an actor's rights under a jurisdictional legal structure, access to key decision makers, hold over popular opinion, or the ability to marshal support for a political leader who can formulate policy. Economic assets are defined as resources which allow an actor to indirectly influence subfederal economic regulations by the weight of their importance to the marketplace, and include access to proprietary technology, capital, key skills, natural resources, or markets. The following section of Chapter Six will use the case study from the previous chapter to analyse how effectively each actor used their assets to fulfill their policy agendas in the debate over California's unitary tax. In doing so, it will reiterate the assets and policy agendas, detailed in Chapter Three, that each actor held during the debate.

a) The federal government

i) Executive

The goals of the executive branch of the U.S. federal government in the debate over California's unitary tax included: appeasing foreign governments which objected to U.S. state use of the worldwide combined unitary (WWC) tax method; fulfilling commitments made through U.S. bilateral tax treaties to support the arm's length

standard; keeping the support of state congressional delegations by avoiding preemptive federal legislation; and maintaining the ability of U.S. states to raise tax revenue during a period of increased fiscal demands. In addition, presidential administrations needed to preserve the support of the California congressional delegation for their legislative proposals, and ensure California's electoral votes supported their reelection. Since California is the most populous U.S. state and has the largest state economy, its continued prosperity was also of key concern to the national government.

Although the federal government was generally consistent in its support of the arm's length standard (ALS), these conflicting goals resulted in a compromised stance against state use of the WWC method. Despite the federal government's public endorsement of the arm's length standard, there were also internal doubts about its accuracy. Further, the 1986 and 1993 revisions to the U.S. Internal Revenue Code, with their use of formulary apportionment-type methods such as the comparable profit interval, further weakened the federal government's stance against state use of the WWC method.

Since state use of the WWC method was not a highly visible public issue, the presidents in office during the 1986 and 1993 California unitary reform legislative solutions had little need to resolve their compromised positions: President Reagan publicly supported business interests while trying to avoid a preemption of state interests, while President Clinton publicly supported state interests while trying to convince the states to change their laws to appease business and foreign governments. As a result, both presidential administrations mustered only weak support for their chosen side and did not effectively use their substantial assets in the policy debate. While President Bush, unhampered by Reagan's federalist concerns, was an active supporter of business interests opposed to the method, his administration did little to move the issue besides file a brief of support for Barclays Bank before the California Supreme Court: this was ineffective, as the court ruled in favour of the state.

The American Republican party has traditionally represented business interests, which were supportive of the arm's length standard. Since California constituted a strong base of Republican support during Reagan's presidency, he did not need to cater to the

state. However, Reagan had supported the state's right to use the WWC method when he was governor of California, and Reagan wanted to help all the states maintain robust revenue bases during his push for fiscal federalism. Although the Reagan administration reassured business interests and foreign governments that it was opposed to subfederal use of the WWC method, many viewed this as a "throwaway line".[2] Despite implied promises to the British, Reagan avoided introducing federal legislation banning subfederal use of the WWC method after the 1979 U.S./UK tax treaty failed to do so, and his Solicitor General did not file an amicus brief supporting the 1983 Container Corporation law suit against California's Franchise Tax Board.[3] Reagan then ignored the recommendations of both his Treasury Secretary and the 1983 Cabinet Council of Economic Advisors to support Container's Petition for Rehearing and introduce federal legislation banning the WWC method, buying time for states to change their unitary laws on their own.

Given Reagan's ambiguity, his most effective deployment of federal government assets proved to be his use of the government's prestige through the formation of the Worldwide Unitary Working Group to draw the different actors in the policy debate together to make progress towards a solution. Reagan's instructions to his Treasury Department to draft federal legislation banning state use of the WWC method in November of 1985 were seen as only "a necessary good faith follow-up" to the Working Group report's promise to implement federal legislation if states did not act within a year to pass their own legislation.[4] In addition, it was made clear that the White House would not take an active role in supporting this legislation, which was withdrawn after California modified its unitary method in 1986.[5]

Bill Clinton was much more dependent on California's electoral votes for a victory in the 1992 presidential election. Fear of Japanese economic competition had contributed to a political environment where foreign investors in the U.S. were seen as not being good corporate citizens: Clinton played to this populist sentiment by championing a crackdown on tax evasion by foreign MNEs. [6] In this, he was propelled by the traditional labour base of the Democratic political party, which supported protectionist measures against foreign investment. As a result of these pressures, Clinton promised to

back California in the unitary debate and urged the U.S. Supreme Court not to hear the 1993 Barclays case. However, Clinton also sought to mollify business interests: when forced to file an amicus curaie brief in the Barclays case, he only weakly supported California, and pledged to work with business and foreign governments to help resolve problems stemming from state use of the WWC method.

In addition to making only qualified use of its political assets, the executive branch did not effectively employ its shrinking economic assets. Although the federal government can theoretically influence state policies by promising or withholding economic help to states in the form of grants or subsidies, during the period when the unitary tax controversy reached its peak (1980-1993), the federal government was undergoing both a period of fiscal deficits and a policy shift to place more of its revenue burden on the states through 'fiscal federalism'. This meant the national government did not have a large amount of revenue available to use as an enticement to states, and its increased reliance on the states to finance unfunded mandates in a wide range of areas made the prospect of economic censure over state tax policies untenable.

ii) Judiciary

The goal of the judiciary in the debate over California's unitary tax was ultimately to maintain the separation of powers of the different branches of the national government by upholding Congress' right to decide whether a state economic regulation interferes with federal powers. Although U.S. courts have the ability, under the Supremacy Clause of the U.S. Constitution, to overrule state laws which conflict with federal laws or treaties on interstate or foreign commerce, this political asset was not invoked by the U.S. Supreme Court, which ruled in the 1993 *Barclays Bank Plc* v. *Franchise Tax Board* case that California's tax method could stand in contravention of federal tax practice since Congress had not passed a law or a treaty explicitly banning state use of the WWC method. The arm's length standard, codified in various U.S. bilateral tax treaties which did not specifically include subfederal laws in their domain, was judged not to overrule state laws if the treaties were not accompanied by U.S. implementing legislation which specified preemption of subfederal tax methods.[7] The judiciary also refused to use its power under the informally-developed dormant commerce clause to repeal a state law

which potentially interfered with national commerce if Congress had not passed legislation preempting the state law. The judiciary thus effectively acted through inaction, placing the impetus to overrule California's use of the WWC method clearly on Congress.

iii) Legislative

Congress held strong assets in the unitary tax debate, since under the Commerce Clause of the U.S. Constitution, Congress can outlaw any state policy which interferes with interstate or foreign commerce. However, Congress did not seriously attempt to pass preemptive legislation outlawing California's use of the WWC method, viewing state taxation powers as an issue of state sovereignty. Frequently introduced congressional legislation was instead a means for the federal government to seem to address the unitary issue while waiting for California to resolve the matter on its own, and never proceeded beyond committee hearings to a full vote.[8] In fact, California did resolve the matter on its own by modifying its regulatory environment in order to attract business to the state. The U.S. Congress is at heart a forum of state interests, and a ban on the WWC method would have deprived many states of tax revenue.[9] In addition, the California congressional delegation, the largest in Congress, was very supportive of the state's desire to maintain the WWC method, or at least modify the method in the manner most beneficial to the state, and its assistance would have been vital in any attempt to pass preemptive federal legislation.[10]

Although any state law which conflicts with a U.S. treaty is considered void, since U.S. treaties cannot be enacted without Senate approval, Congress holds the ultimate power in any executive branch attempt to override state laws by treaty. Congress effectively used this asset during the 1979 U.S.-UK tax treaty negotiations, when the Senate refused to allow the passage of a treaty denying California's right to apply the WWC method to British firms. In this case, state interests successfully argued that preemption of state powers through the treaty-making process would unlawfully deprive states of their rights: only a congressional law could ban a state tax practice.

Therefore, Congress effectively employed its assets in the unitary debate by refusing to use its power to ratify a tax treaty or pass legislation banning state use of the

WWC method.[11] As the U.S. Supreme Court ultimately decreed, Congress acted through inaction.[12] However, the continued introduction of legislation proposing to ban state use of the WWC method and the various subcommittee meetings to consider the issue from the 1960s through the 1980s did pressure the states to resolve the problem on their own.[13]

b) The State of California

California held considerable economic and political assets in the unitary tax debate: it is the largest U.S. state economy, has the largest U.S. congressional delegation, and holds the largest number of electoral votes. These assets gave the state a considerable amount of power at the national level to maintain its right to use the WWC tax method. As a result, there was "tremendous restraint" shown by both the executive branch and Congress to allow California to change its unitary method on its own.[14]

The state also benefited from its belief that California is different from the rest of the United States. State policymakers strongly believed that California has a separate perspective on most policy issues, which the state was free to act on until stopped by the judiciary.[15] In addition, California has a large, independent tax bureaucracy, which was able to enforce the WWC method very effectively.[16] This efficiency and independence led to "intransigence" on the part of California's Franchise Tax Board (FTB): a refusal to be flexible about ceding its position during the unitary debate.[17] The FTB also maintained the upper hand in much of the negotiations since it possessed confidential data on companies' state tax returns, and could therefore claim its estimates of the revenue impact of any proposed changes to the unitary method were the most accurate. Although California modified its unitary method in 1986, the state maintained its right to use the WWC method, its right to charge companies a fee for exemption from the method, and its right to revoke a company's exemption, rights other U.S. states did not attempt to enforce.

However, the states' goals of maintaining a healthy economy and attracting investment grew increasingly more difficult as California both became more dependent on foreign investment in the mid-1980s and underwent an economic recession in the early 1990s. California's declining economy and rising state budget deficits gave it a strong incentive to modify its WWC method in order to make the state more attractive to

business at a time of increased competition for foreign investment. Despite this, the state's considerable economic assets in the 1980s allowed California to be the only U.S. state to maintain the right to overturn a company's decision to file under the ALS method and to charge companies a fee for filing under the ALS. In 1993, the state's political assets allowed it to negotiate a favourable U.S. Solicitor General brief from President Clinton in the Barclays court case, and the U.S. Supreme Court upheld California's right to impose the WWC method, allowing the state to avoid paying back taxes already collected under the method. California was therefore very effective in using its, although depreciated, still-considerable assets to achieve its goals.

c) State associations

State association groups sought to maintain state taxing authority as "one of the basic tenets of state autonomy", particularly during the early 1980s, when state finances were under growing strain in an era of fiscal federalism, and in the early 1990s, when state finances suffered during a nationwide recession.[18] This goal constituted part of the U.S. states' policy agenda during the unitary tax debate.

At the time the unitary debate was originally coming to a head in the early 1980s, the U.S. Supreme Court's 1985 *Garcia* v. *San Antonio Metropolitan Transit Authority* and 1988 *South Carolina* v. *Baker* rulings declared that the U.S. Constitution contained no substantive protection for state and local governments against national regulatory powers. These court cases were of grave concern to the states, who feared federal legislation preempting subfederal powers would now go unchallenged by the courts. The cases further mobilised state interest groups to fight for the states' right to use the WWC tax method by lobbying Congress and the executive branch.[19] In addition, state groups filed numerous amicus curaie briefs defending their right to implement the WWC method in court cases contesting the legality of the method. Individual states and state associations possessed various assets during the debate. In general, state association groups were effective in using their political assets before Congress, the executive branch, and the courts to prevent federal legislation or a court decision from preempting state sovereignty.

However, states were less effective in their use of economic assets. State cooperation on the WWC issue was hampered by interstate competition to attract MNE investment, an area where money and prestige are at the forefront and cooperation is at a minimum.[20] Many states were pleased to gain a competitive edge over California, a prime destination for investment, and did not effectively make use of their main economic assets, their control over U.S. market access, by banding together to implement the method.[21] At the behest of Japanese companies, several states made promises not to use the WWC method, and states openly bragged of new foreign investment they claimed to have received at California's expense as a result of not implementing the WWC method.[22] Although state use of the WWC method was generally agreed to be on the margin of MNE investment decisions,[23] many states did not feel the additional revenue they could gain from using the method was worth the effort of defending it against court cases and the business community.[24]

d) Domestic-domiciled MNEs

The goals of U.S.-domiciled MNEs in the unitary debate included wanting to pay as few taxes as possible and promoting the principle of a 'level playing field' between themselves and their foreign competitors by having all MNEs adhere to the same set of transfer pricing standards.

Although the Committee on State Taxation had been lobbying quietly on the unitary tax issue for years, domestic-domiciled companies had found it difficult to support concrete legislation modifying state unitary methods because their interests were too diverse. While foreign MNEs wanted the WWC method banished entirely, some U.S. companies benefited from the tax method, some were completely opposed to its use, and others wanted the method to be optional. In addition, in the early 1980s, most American companies in California did not belong to political action committees that lobbied on state tax issues; pressures within the state to change the method came primarily from Japanese MNEs. Pressures from the federal government to change California's WWC method focused mainly on how the method affected foreign-domiciled MNEs, since foreign governments had been lobbying the U.S. government over the method's perceived treaty violations. Further, a foreign-only solution was seen as an appealing solution for the state

government: since it involved fewer companies, a foreign-only solution would cost less.[25] Accordingly, initial proposals for unitary reform in California did not include domestic-domiciled companies.

Since foreign-domiciled companies had originally raised the cry against California's unitary method, U.S. companies were "playing catch-up"[26] on the issue in a "defensive reaction"[27] to fears that California would only exempt foreign-domiciled MNEs from the WWC method. When foreign-only exemption legislation was close to passage in the California legislature, U.S. companies realised they needed to press for their inclusion, and formed lobbying coalitions alongside the principle Japanese groups. The creation of the California Business Council (CBC) in 1985, along with increased membership in the Committee on State Taxation (COST), helped demonstrate the collective strength of U.S. MNEs in California.[28] Although they were late to the game, and working at a disadvantage to foreign-based MNEs, domestic-domiciled MNEs were ultimately effective in insisting on their inclusion in any exemption from the WWC tax method.

Led by the CBC and COST, U.S. companies used their newly-discovered political assets to stress their status as constituents in California and effectively play the "foreign card" by arguing they should not be disadvantaged by state legislation which gave an exemption only to foreign-domiciled companies.[29] Silicon Valley firms in particular argued any measure which helped Japanese high-tech firms would come at their expense. This constituency argument was especially effective since both sponsors of the California state legislation (Senator Alquist and Assemblyman Vasconcellos) were from the San Jose district, home to California's nascent high-tech industry. These arguments were ultimately successful in gaining the inclusion of domestic-domiciled MNEs in the 1986 California unitary reform legislation.

Domestic companies also used their economic assets at the state level by threatening to diminish their investment in California. However, they had less leverage here than foreign companies, as their investments were longer-standing and their ties to the state greater. Threats not to increase their existing investments in the state became

effective only during the recession of the early 1990s.[30] In the lead-up to California's 1993 unitary tax reform, U.S. MNEs also argued they feared retaliation from foreign governments offended by California's use of the WWC method. The UK's threatened retaliation, made concrete by a letter-writing campaign to MNEs, encouraged many U.S. firms to press California to change its law.[31]

Domestic-domiciled MNEs were effective in latching on to the more persuasive court cases being waged by foreign-domiciled MNEs. After the U.S. Supreme Court ruled in the 1983 Container case that domestic-domiciled MNEs could be taxed under the WWC method, their legal position was weak. However, they reasoned that if foreign MNEs were exempted from the method through foreign policy considerations, domestic MNEs could argue for a similar exemption on the grounds of equity with foreign competitors. Colgate-Palmolive successfully used this argument to have its case against California's Franchise Tax Board joined with Barclays Bank's suit before the U.S. Supreme Court.

e) Foreign-domiciled MNEs

While U.S. MNEs most often favoured making the WWC method optional, since some benefited from using the method, most foreign companies favoured a complete abolishment of the tax. Foreign-domiciled MNEs effectively used their economic assets at the state level by simultaneously contributing large amounts of money to political candidates, promising new investment in California if the WWC method was removed, and threatening to withdraw existing investments if it was not. Pressure in this direction from Japanese MNEs was particularly effective because California saw its economic interests as closely aligned with the Pacific Rim, and because the Japanese held the promise of desirable high-tech manufacturing jobs.

Indeed, Japanese MNEs were seen as "playing hardball" since they directly stressed the link between their investments and a change in California's WWC method, announcing increased investment in the state immediately after the WWC method was modified in 1986.[32] While the Japanese were effective in relying on their economic assets, the British initially did not. Since most British subsidiaries in California were

long-established, they could not threaten to withdraw their investments from the state as plausibly as the Japanese. British MNEs were also seen as less willing to compromise on the unitary issue than the Japanese, since they were much more concerned with the principle of worldwide combined unitary being an incorrect tax method. In line with arguing the issue on principle, British MNEs primarily used political figures as lobbyists: parliamentary delegations, Margaret Thatcher, and members of the British consulate in San Francisco. However, they were not familiar with state lobbying procedures[33] and their "lack of understanding of legislative ego and protocol" hurt their cause.[34]

Foreign-domiciled companies did not ultimately benefit from the stronger legal assets they held, as their legal position was severely weakened when foreign MNEs were paired with U.S. MNEs after the Barclays case was joined with Colgate-Palmolive's in the 1993 U.S. Supreme Court hearing which finally decided the legality of state use of the WWC method.

f) Foreign governments

Foreign governments pressured the U.S. federal government to outlaw any state use of the WWC method, arguing the method violated U.S. bilateral tax treaties. The British were most effective in negotiating with the White House since good U.S./UK political relations gave them strong political assets.[35] Although only weakly supported by the U.S. federal government, the Worldwide Unitary Working Group and the 1985 introduction of federal legislation, which resulted in large part from British pressure on the Reagan administration, did add to pressure on California to change its unitary method.

However, pressure from foreign governments and foreign MNEs at the federal level set off an argument between the national and state governments over federal preemption which harmed the foreign governments' case, since it cast the debate in federalist terms, which ultimately led to a ruling in favour of California in the decisive Barclays court case. The British in particular raised hackles with their perceived assumption that the federal government could unilaterally change California's law:[36] this added to the states' perception that foreign governments were colluding with the national government against them.[37]

At the state level, the most effective asset foreign governments had was their prestige and the novelty of their involvement at the subfederal level. These assets were fully neutralised by a strong California sense of prestige and the fact that foreign governments were not state constituents. The Japanese government, which relied on its corporate representatives to lobby and was quicker to approach the states directly, was more successful than European governments in lobbying at the state level. In particular, the 1984 Keidanren Investment Expansion Mission received pledges from seven U.S. states not to enact a WWC method.

However, foreign governments were fairly effective in converting their economic assets into political assets. Both the Japanese and EU member governments threatened to revoke bilateral tax treaties with the U.S. if the U.S. federal government did not prevent the states from applying the WWC method to their countries' MNEs, and the UK government threatened economic retaliation over the issue in both 1985 and 1993. Although these threats most probably did not seriously worry the U.S. federal government, since they would constitute treaty violations justifying U.S. retaliation, they encouraged the White House to introduce federal legislation banning the WWC method in 1985 and contributed to California's introduction of further reform in 1993, when the state had entered an economic slump and could little afford any damaging action directed against companies operating in California.[38]

g) International organisations

The Organisation for Economic Cooperation and Development (OECD), the only prominent international organisation actively working on tax policy at the time of the debate over California's unitary method, sought a uniform application of the arm's length standard (ALS) to all national and subfederal jurisdictions to promote a uniform global business environment. Debate over U.S. state use of the WWC method led the U.S. government to push the OECD in 1993 for a more precisely defined and circumscribed ALS system, which it hoped would be more effective. However, the U.S. government also sought discrepancy in these negotiations for its optional profit splitting and comparable profit interval methods of evaluating transfer prices, methods which were

seen by both MNEs and European governments as at odds with the ALS. While supporting a more effective international norm, European governments opposed any dilution of the arm's length standard. Both foreign and U.S. MNEs also lobbied against any U.S. use of formulary apportionment-type methods through the Business and Industry Advisory Committee of the OECD.

These internal divisions over the use of optional formulary apportionment-type methods meant the OECD was not an effective forum for resolving the debate over U.S. state use of unitary tax methods. In addition, the OECD had no direct power to enforce its standards at the U.S. state level, and it was reliant on a U.S. government unwilling to preempt state tax powers to enforce OECD transfer pricing norms. The only other international organisation which could have had an influence on the debate was the GATT, which, at that time, did not consider forms of direct taxation within its remit, had extremely weak enforcement powers, and had no direct rule over subfederal governments. The incoherence in international taxation norms meant that international organisations were not effective players in the debate over California's unitary tax. Further, the political and economic assets held by international organisations at the time of the unitary tax debate were weak.

3) The use of different negotiating channels

State-firm bargaining takes place within institutional settings for negotiation, and these settings play an important role in structuring and influencing the bargaining process. As described in Chapter One, when actors deploy their assets, they do so through channels of negotiation: actors who can be used to influence a host government.[39] The model of bargaining at the subfederal level detailed here includes the negotiating channels of the U.S. federal government, the state of California, the U.S. court system, and international organisations. Therefore, several of the actors active in state-firm bargaining at the subfederal level can also be considered to be channels of negotiation. This section of the chapter will examine which actors used, or failed to use, the channels listed below effectively.

a) The U.S. federal government

Lobbying at the level of the U.S. federal government was undertaken by:

i) **Multinational enterprises**, both directly, and through their home governments, MNE interest groups, and international organisations (see Figure 18, on p. 258, for a diagram of the various actors which used the federal government as a negotiating channel during the unitary tax debate). MNEs were particularly successful in appealing to the U.S. Treasury Department, which pressed their case within the White House as part of its continuing effort to support the arm's length standard. Influenced by the Treasury Department, the Reagan administration attempted to deal with MNE complaints through the formation of the Worldwide Unitary Working Group. However, companies relied too heavily on the executive branch to achieve a solution at the federal level. MNEs were less effective in gaining support in Congress, which more strongly represented state interests. At this level, although foreign business interests were generally unsuccessful in gaining Congressional support for preemptive legislation, lobby group such as the European-American Chamber of Commerce, the National Foreign Trade Council, and the Organization for International Investment argued forcefully that foreign-domiciled companies investing in the United States were worthy of support since they were strong contributors to the U.S. economy and, particularly, to U.S. employment.

Foreign-domiciled companies were more effective at the level of the U.S. federal administration, where foreign governments could pressure the U.S. administration on perceived treaty violations; domestic-domiciled companies were more successful in lobbying Congress, where they held a stronger constituency argument, although state interest groups ultimately held sway in this arena. Moreover, MNE lobbying at the federal level turned the unitary debate into an issue of federal preemption of state economic powers. This dynamic made the issue more contentious and often overrode any discussion of the merits of the tax method itself.[40]

ii) **Foreign governments** first became involved in the unitary debate during negotiations over the 1979 U.S./UK bilateral tax treaty, when British MNEs pressed their government to ask that British firms be exempted from state WWC methods. After the

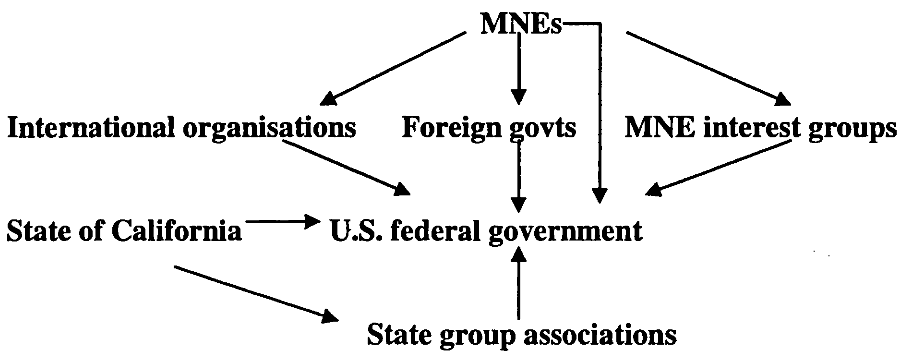
treaty exemption failed to pass the U.S. Senate, the British government lobbied the U.S. federal government to introduce legislation banning state use of the method in 1985 and to push the legislation into congressional hearings in 1986, threatening economic retaliation if the White House did not move the issue forward. EC national governments also threatened to suspend their bilateral tax treaties with the U.S. if Congress did not pass a law banning state use of the WWC method after the 1983 Container decision. Foreign governments were effective in lobbying the U.S. Treasury Department and the U.S. Secretary of State, both of which were concerned that state use of the WWC method violated U.S. tax treaties. However, foreign governments were most comfortable dealing with the executive branch of the federal government, and the unitary issue was ultimately not decided here. Although there was only limited foreign government lobbying in Congress, it is unclear whether an increased effort here would have been effective.

iii) **The State of California**, which pressured the federal government through its large congressional delegation, the participation of state personnel in the Worldwide Unitary Taxation Working Group, and membership in various state association groups which lobbied the federal government (again, see Figure 18 on p. 258). California was very effective in using its powerful congressional delegation to halt any attempts at a legislative ban on state tax practices, but only moderately effective in lobbying the executive branch. Although successive presidents and presidential candidates were eager to curry favour with the state's large base of electoral votes, federal agencies were under simultaneous and effective pressure from business interests and foreign governments to change California's tax method.

There were also less formal interactions between the state and federal level: California Governor Jerry Brown publicly endorsed an early version of the 1979 U.S./UK tax treaty banning state use of the WWC method, while the head of the California FTB simultaneously organised opposition to the treaty among tax officials in other states; Governor Deukmejian proposed state legislation banning the WWC method in 1984 in an attempt to avoid an embarrassing conflict with the Reagan administration; and the chairman of California's Board of Equalization successfully lobbied presidential candidate Bill Clinton in 1992.[41]

iv) **State group associations** have a long history of lobbying the U.S. federal government in support of the states' right to use the WWC method.[42] They were successful in forestalling the introduction of preemptive legislation in Congress until 1985, which allowed many states time to modify their unitary tax regulations themselves. State groups also lobbied the federal government through their participation in the Worldwide Unitary Working Group. Although unable to achieve their goals within the Group or to halt the issuance of a final report which did not incorporate their position, state assets were strong enough to allow them to refuse to agree to the final report. In addition, state groups received support from the Office of Intergovernmental Relations, a powerful force for state sovereignty within the early Reagan administration.[43]

Figure 18: Lobbying the U.S. federal government



b) Lobbying the state of California.

Lobbying the state of California was undertaken by:

i) **Multinational enterprises**, both directly, through industry associations, and by influencing their home governments (see Figure 19 on p. 260 for a diagram of this dynamic, along with that of other actors lobbying the state of California). The unitary debate was the first time Japanese and Silicon Valley companies mobilised to lobby extensively in California,[44] as the level of foreign investment in the state reached a critical mass in the mid-1980s. This channel of negotiation proved extremely effective in its directness, since the

business community is considered highly influential in California's political process;[45] in addition, the industries most affected by the unitary tax method were high-tech manufacturing companies, the industries the state most wanted to attract. This lobbying channel became even more effective in 1993, when MNE threats of withdrawn investment were taken more seriously as the California economy declined.

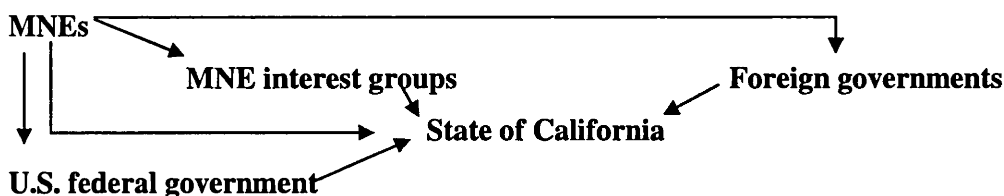
ii) **Foreign governments**. During the time of the unitary debate, California's political structure did not have established channels to effectively handle direct lobbying by foreign governments: there was no "port for the modem" of foreign governments at the state level.[46] At the same time, foreign governments, particularly the British, had a "lack of appreciation" for the states as sovereign entities which held power independent of the national government.[47] Furthermore, foreign governments did not want to have to negotiate with U.S. subfederal governments since it "feels bad" to have a subfederal government put forward a law with extraterritorial reach.[48] This perspective may have been a contributing factor to the conflict, since foreign governments initially did not approach California directly, bypassing the state level in favour of lobbying the U.S. federal government through established diplomatic channels (see Figure 18 on p. 258).[49] Eventually, however, there was a realisation that it could be "extremely difficult" for the U.S. Congress to pass legislation banning state use of the WWC method, and foreign government lobbying began to focus on the subfederal level;[50] the unitary issue therefore triggered a "much more acute awareness of California" on the part of foreign governments.[51] As show by Figure 19, p. 260, foreign governments did eventually approach the state of California directly.

The Japanese were the first foreign government to open up a direct channel of negotiation with California in 1977 when Governor Jerry Brown requested agricultural trade concessions from the Japanese government, who in return demanded a removal of the WWC method. The Japanese government was viewed as an effective lobbyist in California in part because it relied on Japanese companies to approach the state, which "looked like something California expected to see".[52] In addition, California was very interested in developing an economic and strategic alliance with the Pacific Rim and looked to Japan for important technological input and manufacturing investments.[53]

The British government was less effective in lobbying California. Although the UK government felt they "naturally were put in the lead as the largest investor in the U.S.", and brought in delegations of government officials to hold meetings with state personnel, to state government officials, they appeared condescending.[54] They were therefore seen as ineffective in presenting their case until they directly threatened California with economic retaliation in 1993.[55]

iii) **The U.S. federal government** pressured California by attempting to exempt British firms from state WWC unitary tax methods during negotiations over the 1979 U.S./UK tax treaty, holding various congressional subcommittee meetings on legislation to modify state use of the WWC method,[56] and introducing federal legislation banning state use of the WWC method in 1985 (again, see Figure 19 below). However, states felt the Reagan administration "wasn't serious" about the legislation, and it was withdrawn after California reformed its unitary method in 1986.[57] At the same time, the federal government attempted to cooperate with California through the Worldwide Unitary Taxation Working Group, and through offers to assist the states in collecting financial information from MNEs.

Figure 19: Lobbying the State of California



Although these efforts kept pressure on California to reform its unitary tax, the national government showed tremendous restraint during the debate over California's tax method because the political ramifications of acting in a way which would significantly harm California fiscal interests were "dramatic" and "there was great reluctance for the federal government to tell the states what to do with their tax policy".[58] Attempts at coercion were unsuccessful because of this deference, and because it became evident that,

constitutionally, it would take an act of Congress to force a change in the state's tax policy.[59] This was an unpromising channel for change, since most congressmen did not want to vote to preempt a state power while concurrently depriving their constituencies of a potential revenue base.

c) Contesting the legality of the WWC method in the courts.

i) **Multinational enterprises** filed various lawsuits against California alleging that the state was overstepping its powers in applying the WWC method.[60] In addition, MNEs and MNE interest groups filed numerous amicus curaie briefs in support of companies contesting the WWC method's legality in court cases (Figure 20, p. 263, shows the various actors which used the U.S. courts as a negotiating channel).[61] This channel of negotiation proved a highly effective means of intimidating California, since any ruling against the state could have forced California to pay back all the revenue the state had collected under the method, while drastically reducing state revenue projections.[62] This threat proved particularly effective in the 1993 Supreme Court hearing of the Barclays/Colgate-Palmolive case, when the state was in dire financial circumstances.[63]

ii) **The U.S. federal government** was a potent lobbyist within the court system, since its ability to conduct foreign policy was a key factor in decisions on the legality of state use of the WWC method (see Figure 20, p. 263). The federal government filed amicus curaie briefs supporting an overthrow of state use of the WWC method in the 1981 *Chicago Bridge & Iron Company* v. *Caterpillar Tractor Company, Illinois Department of Revenue* case, the 1986 *Alcan/ICI* suit against California's Franchise Tax Board, at all stages of the *Barclays Bank Plc.* v. *Franchise Tax Board* case in the California court system, and at a 1992 U.S. Supreme Court hearing to decide whether the Barclays case would be heard on appeal. However, the federal government refused to file a supportive brief in the 1983 *Container Corporation of America* v. *Franchise Tax Board* case or support Container's Petition for Rehearing. As well, neither the Bush nor the Reagan administration filed amicus briefs in support of Colgate-Palmolive's legal battles, fueling claims that the White House was more concerned about the effect of the WWC method on foreign companies.

There is also evidence to suggest that the desire to ensure a supportive U.S. Solicitor General brief in the 1993 *Barclays Bank Plc.* v. *Franchise Tax Board* case convinced the California government to modify its unitary method in 1993.[64] President Clinton had given legislators in California the impression that he would not ask for a favourable Solicitor General brief without a change in California's law, and a favourable brief was seen as crucial to overcoming Barclays' arguments that the WWC method violated the national government's ability to conduct foreign policy.[65]

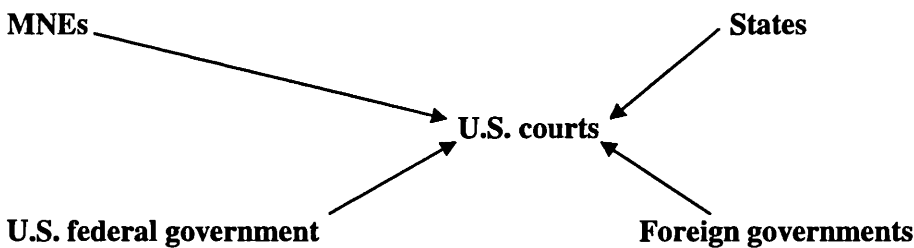
iii) **The states** also sought to maintain their legal right to use the WWC tax method even if they chose not to implement it, since revenue-raising policies are considered a key component of state sovereignty.[66] The states effectively used the judiciary as a negotiating channel by arguing the unitary tax issue on federalist grounds, winning rulings in the following court cases: *Bass, Ratcliff and Gretton Ltd.* v. *State Commission* (1924), *U.S. Mobil Oil Corp.* v. *Vermont* (1980), *Exxon Corporation* v. *Wisconsin* (1980), *Container Corporation of America* v. *Franchise Tax Board* (1983), *Alcan Aluminium/ICI* v. *Franchise Tax Board* (1992), *Barclays Bank Plc.* v. *Franchise Tax Board* (1993), and *Colgate-Palmolive* v. *Franchise Tax Board* (1993).

State group associations filed numerous amicus briefs supporting the states' right to use the WWC method.[67] These associations also lobbied the U.S. Solicitor General to support the states. In particular, the National Governors' Association successfully lobbied President Reagan to support California by not filing an amicus curaie brief in the 1983 Container Corp. case.[68]

iv) **Foreign governments** assumed early in the unitary fight that because the U.S. administration opposed state use of the WWC method, it would be ruled unconstitutional in federal court. They assumed the lack of a supportive U.S. Solicitor General brief in the 1983 Container case had led the U.S. Supreme Court to rule in favour of state use of the WWC method as applied to domestic corporations. Foreign governments unsuccessfully lobbied the White House to support Container's Petition for Rehearing (again, see Figure 20 on p. 263). The British government then applied political pressure on the U.S.

administration at the final stages of the 1993 Barclays litigation for a favourable U.S. Solicitor General brief, to no avail. Foreign governments also filed numerous amicus curaie briefs in support of companies fighting state use of the WWC method through U.S. courts.[69]

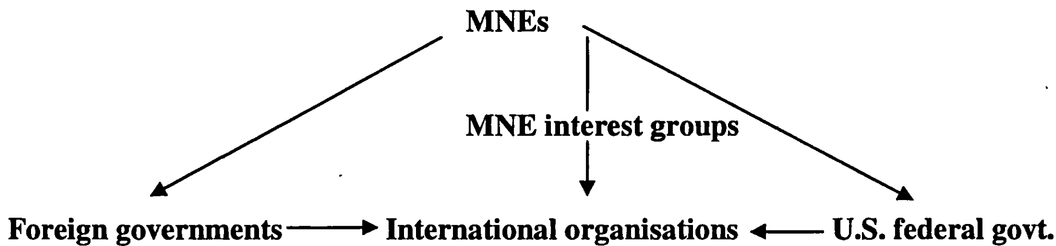
Figure 20: Lobbying the U.S. courts



d) Lobbying international organisations

Lobbying at the level of international organisations, most notably the Organisation for Economic Cooperation and Development (OECD), was undertaken by various national governments and MNE interest groups (Figure 21, p. 264, shows the various actors which used international organisations as a negotiating channel during the unitary tax debate). These groups sought to use international organisations both to influence U.S. state governments and to put pressure on the U.S. federal government to push the states to reform. International organisations proved a weak intermediary channel for negotiations, since, at the time of the unitary debate, no international organisation regulating tax issues had an effective enforcement mechanism or mandate to act at the subfederal level, and there was no definitive consensus among the OECD member countries on transfer pricing standards.

Figure 21: Lobbying international organisations

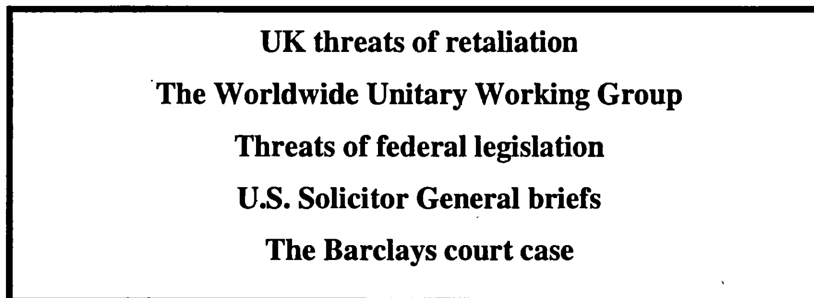


The debate over California's unitary tax method did lead to increased efforts within the OECD, led by the UK and U.S. governments, to resolve national differences on transfer pricing standards through more stringent OECD definitions. The 1995 report of the OECD's special task force of the Committee on Fiscal Affairs rejected the use of unitary taxation much more specifically than in previous OECD reports, condemning the "pre-determined and mechanist nature of global formulary apportionment methods".[70] However, the 1995 report still reflected an incoherent regime for international taxation, as the U.S. successfully lobbied for the inclusion of its federal formulary apportionment-style methods over the protests of European governments.

4) Key initiatives

Initiatives occur when actors deploy their assets through channels of negotiation in bargaining over subfederal government policies which violate international norms. If actors find a highly effective use for their assets, their initiatives can push a policy debate towards a solution. Such highly effective uses of assets and channels of negotiation are examples of the successful culmination of state-firm bargaining since they demonstrate an actor's conversion of their potential power into actual influence over the outcome of a policy debate.[71] This section of the chapter will highlight key initiatives, shown in Box 4, p. 265, which brought the various actors towards a solution in the debate over California's unitary tax method.

Box 4: Key initiatives in the California unitary tax debate



UK threats of retaliation

The Worldwide Unitary Working Group

Threats of federal legislation

U.S. Solicitor General briefs

The Barclays court case

a) UK threats of retaliation

In May 1985, the British government, frustrated that the federal Worldwide Unitary Working Group had not succeeded in eliminating state use of the WWC method, sponsored parliamentary legislation proposing the denial of advance corporation tax (ACT) credits on dividends to companies having a "qualifying presence in unitary tax states"[72] if the U.S. Congress did not pass legislation banning subfederal use of the WWC method by January 1987.

The threat of UK retaliation did not carry a huge amount of weight at this time, since it would have been a violation of the existing U.S.-UK tax treaty, and thus a legal justification for U.S. economic retaliation.[73] However, it added to pressure on President Reagan, and helped lead him to introduce federal legislation in 1985 banning state use of the WWC method. This meant the UK was effectively employing an additional negotiating channel, the U.S. federal government, to influence U.S. states. The proposed federal legislation, combined with the threat of UK retaliation, helped convince the California legislature to reform its unitary tax method in 1986.

The UK government threatened economic retaliation again in May of 1993, announcing it would revoke ACT credits for all companies which had headquarters or operations in California unless the state revoked its WWC tax method. UK threats of retaliation were taken more seriously this time, since the UK government was now directly targeting California-based companies.[74] More importantly, the threat was amplified when UK Inland Revenue sent letters to 900 U.S. companies operating in

California. This provided concrete evidence U.S. MNEs could use to argue their case before the California legislature and that the federal government could use as evidence to pressure the state.[75] In this instance, the UK government was effectively using two additional negotiating channels to influence the California government: the federal government and MNEs. In addition, threats of economic retaliation had more weight by 1993, since the California economy had deteriorated considerably since 1985.[76]

Although California bureaucrats working on the unitary issue seemed to view the UK's retaliation threats with bemusement, state politicians took the warnings more seriously.[77] California Senate Committee staff stated they had been unofficially assured by the UK government that their proposed 1993 unitary reform law would be enough to remove the threat of retaliation, and Senator Alquist stressed the need to head off UK reprisals with the passage of his bill. California's unitary reform law needed to be passed by September 10, 1993 to ensure the bill would be made into law by January 1, 1994, the UK government's deadline for avoiding retaliation. The bill, voted in on September 11, 1993, just made the cut-off. These threats of retaliation were an example of a foreign government successfully converting its economic asset, its host government status with many American MNEs, into a political asset, the threat of suspended economic rights for those U.S. MNEs, in a way that successfully prompted California legislative staff to pass a unitary reform bill.

b) The Worldwide Unitary Working Group

The 1983 Worldwide Unitary Working Group was a product of the U.S. federal government's incoherent policy agenda over state use of unitary tax methods. The Reagan administration sought to reassure foreign governments and business groups, upset over the Container decision, that the federal government was working to resolve problems with state use of unitary tax methods. At the same time, it sought to avoid the introduction of preemptive federal legislation which would have violated Reagan's federalist principles. A divided final report proved the Working Group had made no progress in getting state and business groups to compromise and ensured hard-line states like California would not be persuaded to change their laws.

However, the Working Group was successful in that it allowed the federal government to demonstrate that the WWC method was a problem which needed to be addressed, laid out a blueprint of different possible solutions,[78] and educated state representatives on the issue.[79] In particular, California Governor Deukmejian returned from participation in the group convinced that the WWC method was a problem, both for the business community and the Reagan administration, and determined to resolve it by introducing state legislation to reform California's unitary method.[80] In addition, the final report of the Working Group, in conjunction with increased MNE lobbying, helped lead five states to stop using the WWC method.

Therefore, although the very existence of the Working Group, in the absence of other clear federal government action on the unitary issue, was an example of the government's incoherent policy agenda, the Working Group can be said to be a successful attempt by the U.S. federal government, which lacked the internal resolution and political will to resolve the unitary tax debate itself, to use its political power to draw together the relevant actors in the debate and force resolution of the issue onto the states.

c) Threats of federal legislation

Although the Reagan administration introduced federal legislation banning state use of the WWC method in November 1985, there seemed little chance that the law would be approved. Federal legislation banning the WWC method had been proposed for many years,[81] but had never proceeded beyond committee hearings to a full vote: there seemed even less chance the legislation would have enough political support to pass now, when fewer states were using the method.[82] A divided Working Group report had demonstrated the states' refusal to accept federal preemption of their taxation powers. In addition, state groups felt it would be difficult for Congress to preempt the states on an issue which had not been ruled illegal or unduly egregious by the courts.[83]

However, the California House/Senate conference committee working on unitary reform legislation publicly stated in May 1986 that they were anxious to reach a compromise before a scheduled September 29th congressional subcommittee hearing on the proposed ban. After California changed its law on September 5, 1986, the federal

government withdrew its proposed legislation at the subcommittee's opening hearing, stating it was satisfied that California's legislation resolved the problem. There is a general consensus that although the threat of preemptive legislation was not serious, the federal government's threat had served its purpose by adding to pressures on California to change its unitary method on its own.[84] The mere threat that the federal government would use its ultimate political asset, its ability to overrule state regulations, was sufficient to affect the progress of legislation at the state level.

d) U.S. Solicitor General briefs

There is evidence to suggest that the desire for a favourable U.S. Solicitor General brief from the Clinton Administration led the California legislature to pass its unitary reform law in 1993, since the California legislature's report on the legislation states that "California officials have been assured that if our law is changed in a manner which will remove the threat (of retaliation), then a neutral brief (to the effect that the Administration does not advise the court to take up the Barclays Case) would be filed".[85] California Senator Alquist, the sponsor of the state's 1993 unitary reform bill, stressed the need to influence the Solicitor General's amicus brief in the Barclays case, and the Fiscal Policy Office of the Senate Rules Committee in California contacted the White House and the U.S. Treasury Department, who helped state tax committee staff work on the bill's language. The California legislature then faxed a copy of the proposed bill to President Clinton to ensure it was sufficient to prompt an amicus brief in support of California.[86] California's unitary reform bill, which effectively neutered the WWC method but maintained the state's right to enforce it, passed on September 11, 1993, and Clinton asked the Supreme Court to drop the Barclays case on October 7, 1993.

Although many credit the Clinton administration's subsequent Solicitor General brief, which weakly supported California, as a decisive factor in the 1993 Barclays case, in the end, it proved tangential to the court's ruling, which concentrated on the need for Congress to maintain its jurisdiction over state economic laws.[87] Nonetheless, the presidential administration's apparent power to politically influence a decisive court case had been enough to prompt the California legislature to action. Moreover, it inadvertently proved to be a deft use of presidential influence: if Clinton had filed in favour of

Barclays, as he was urged to do by MNEs and foreign governments, it ultimately would not have affected the court's ruling, which did not focus on the federal government's ability to conduct foreign policy. Instead, by filing in favour of the state, the presidential administration managed to extract a concession from the state to change its law without alienating state interests, since, without a legal ruling against it, California was able to avoid paying back taxes it had collected under its previous regulations.

e) The Barclays court case

The Barclays Bank case had assumed great importance since it provided a means for the national government to decisively settle the principles involved in the unitary tax debate after the congressional and executive branches had effectively relinquished their jurisdiction on the issue to the courts.[88]

In particular, by the early 1990s, the Barclays litigation had become the main focus of the unitary debate for foreign interests: even after California's unitary reform legislation in 1993, the EC Commission and the European Parliament warned that a legal decision against Barclays could lead to the suspension of EC tax treaties with the U.S. Foreign interests had placed much hope in the Barclays lawsuit.[89] However, some observers felt that California's 1993 unitary reform legislation, introduced just before the Barclays case was decided, allowed the U.S. Supreme Court to hand down a decision which was not economically damaging to California or a preemption of state taxation powers.[90]

Although the unitary debate had landed in the courts for a final decision, the Supreme Court's decision in the Barclays case firmly gave jurisdiction over subfederal economic regulations to Congress. The court's ruling reinforced the power of Congress to overrule state laws which violate international norms, at the same time that it strengthened the court system's importance as a channel for influencing the ability of U.S. states to implement regulations at odds with international norms.

5) Effective use of federal assets

When evaluating the strategies actors used to deploy their assets in the debate over California's unitary tax, it is interesting to note that in several of the examples of highly effective uses of assets, the federal government influenced the outcome of events by merely threatening to use its ultimate political asset: its power to overrule California state legislation. The presidential administration could deploy this asset through Congress, by introducing federal legislation or treaties overriding California's use of the WWC method, or through the courts, by filing amicus curiae briefs in court cases deciding whether to overrule the method on foreign commerce clause grounds. In particular, Congress, through its power to pass preemptive legislation, is a key institution in determining the exercise of state power. These federal assets were so powerful that even in cases where states did not actually believe the federal government would follow through on a threat to pass preemptive legislation or rule a state law illegal, the threat alone was sufficient to affect the outcome of the debate.

Ultimately, the federal government, in particular Congress, could stop state use of the unitary tax method by passing preemptive legislation. Congress is thus the key U.S. institution controlling the exercise of state regulatory power. However, Congress has rarely exercised this power, preferring to leave debates over state power to the U.S. court system. The states actively seek to keep this boundary flexible through direct lobbying of Congress and the U.S. judiciary. Despite the introduction of preemptive federal legislation in 1985, the federal government withdrew its threat after the state reformed the unitary tax method on its own. In the process, California managed to maintain the right to overturn a company's decision to file under the alternative ALS method and charge a fee to companies which did so, despite bitter opposition from powerful MNEs and foreign governments. Congressional preemptive power does, however, remain on the sidelines of any debate over U.S. state regulations which conflict with international norms as a constraining factor on state power which forms the legal boundaries around a state's independence in asserting its interests on the international stage.

6) Summary

This chapter has completed the model of state-firm bargaining over subfederal economic policies which conflict with international norms. Chapter Three defined the first three components of the model being built to evaluate state-firm bargaining at the subfederal level: the actors, their agendas, and their assets. Chapter Six has completed the model by: i) evaluating how effectively the various actors employed, or failed to employ, their assets to achieve their policy agendas in the debate over California's unitary tax method; ii) demonstrating the effective use of various channels of negotiation to influence California's policy; and iii) examining the most effective uses of assets and negotiating channels, key initiatives which influenced the outcome of the policy debate. This chapter has analysed how successfully actors converted their potential power, their political and economic assets, through bargaining into influence on the outcomes of the debate over California's unitary tax policy.

Further, this chapter supports the hypothesis that the U.S. national government will not always be the preeminent channel of negotiation for foreign governments and MNEs seeking to influence U.S. economic policies. During the debate over its unitary method, California bargained directly with foreign governments, foreign-domiciled MNEs, and international organisations, as well as with domestic-domiciled MNEs and the U.S. federal government. The increase in international economic interactions at the U.S. subfederal level has multiplied the number of actors which seek to influence U.S. state economic policies, and resulted in an increased diversification of U.S. foreign economic policy processes. The debate contained negotiations between U.S. federal and state governments, between MNEs and U.S. state governments, between firms within industry associations, between the U.S. federal government and foreign governments, and between foreign national governments. These actors used many different types of assets and channels of negotiation to influence California's unitary policy, supporting Hocking and Stopford and Strange's view of a complex and dynamic state-firm bargaining framework for international economic negotiations.

This chapter also supports the hypothesis that powerful U.S. states such as California can maintain regulatory standards at odds with federal and international norms: the U.S. federal government refused to effectively constrain California's use of a tax method which violated federal and international tax norms. This chapter has demonstrated the various ways actors can effectively influence U.S. state economic policies which conflict with international norms, even those put forth by very powerful U.S. states. As we will see in the final, concluding chapter, this will provide a useful means of looking at how other international conflicts over the economic policies of U.S. states may develop.

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[1] Keohane and Nye, 1989, p. 11.
[2] Interview #23.
[3] Interview #7.
[4] Interview #10.
[5] Interview #7.
[6] Interview #4.
[7] Interview #23 and #10.
[8] 1965 (HR11798), 1966 (HR16491), 1967 (HR2158 and HR7906), 1969, 1971, 1973, 1976, 1977, 1979, 1981 and 1983.
[9] Interviews #3 and #11.
[10] Interview #23.
[11] Ibid.
[12] Interview #7.
[13] Interview #29.
[14] Ibid.
[15] Interview #28.
[16] Interviews #29 and #3.
[17] Interview #29.
[18] Interview #10.
[19] Interview #29.
[20] Interview #10.
[21] Ibid.
[22] The Keidanren Investment Expansion Mission received assurances from 7 out of 23 states visited in February and June of 1984 that they would not use the WWC tax method.
[23] Interview #10.
[24] Interview #1.
[25] Interview #42.
[26] Interview #49.
[27] Interview #25.
[28] Interview #35.
[29] Interview #25.
[30] Interviews #36 and #3.

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[31] Interview #4, #31, #8 and #24.
[32] Interviews #35 and #32.
[33] Interview #7.
[34] Interview #35.
[35] Interview #25.
[36] Interview #18.
[37] Ibid.
[38] Interview #39.
[39] Behrman, Boddewyn, and Kapoor, 1975, p. 99
[40] Interview #18.
[41] Interview #10.
[42] The ACIR lobbied against a 1973 Senate Bill as federal intervention on traditional state powers of taxation; a National Conference of Commissioners for Uniform State Laws held by states to enact UDIPTA in 1965 successfully forestalled U.S. House legislation from the Willis Committee; in 1977, the MTC lobbied Congress to support the WWC method and started its own audit/regulation system to limit criticisms; the MTC also lobbied in 1981 and 1983 against the Conable/Mathias legislation proposing limiting the states' use of the WWC method.
[43] Interview #7.
[44] Interview #28, #36, and #42.
[45] Brief by the California Tax Reform Association et al, in the Barclays/Colgate case, January 19, 1994.
[46] Interview #25.
[47] Interview #18.
[48] Interview #24.
[49] Interview #18.
[50] Interview #50.
[51] Interview #23.
[52] Interview #25.
[53] See Chapter Four.
[54] Interview #50, #25.
[55] Interviews #25, #23, #45 and #30.
[56] 1964 and 1965 House Committee on the Judiciary Subcommittee on State Taxation of Interstate Commerce, 1965 Task Force on Foreign Source Income under the House Committee on Ways and Means, and 1977 House Task Force on Foreign Source Income.
[57] Interview #23.
[58] Interview #3.
[59] Interview #39.
[60] *Barclays Bank Plc* v. *Franchise Tax Board, An Agency of the State of California* (1994); *Colgate-Palmolive Company* v. *Franchise Tax Board, An Agency of the State of California* (1994); *Alcan Aluminium and ICI* v. *California Franchise Tax Board* (1992); *Chicago Bridge & Iron Company* v. *Caterpillar Tractor Company, Illinois Dept. of Revenue* (1981); *Japan Line, Ltd.* v. *Los Angeles* (1979); *Container Corporation of America* v. *Franchise Tax Board* (1983); *Superior Oil Co.* v. *Franchise Tax Board* (1963); *Honolulu Oil Corp.* v. *Franchise Tax Board* (1963); *Bass, Ratcliff and Gretton, Ltd.* v. *State Commission* (1924); *U.S. Mobil Oil Corp.* v. *Vermont* (1980); *Exxon Corporation* v. *Wisconsin* (1980).

[61] For example, in the *Barclays Bank Plc.* v. *California Franchise Tax Board* U.S. Supreme Court case of 1993, amicus curaie briefs in support of the petitioner were filed by the Keidanren (Japan Federation of Economic Organisations), Banque Nationale De Paris; the Japan Tax Association; Reuters Limited; the Organization for International Investment Inc. and the Union of Industries and Employers' Confederations of Europe; the Committee on State Taxation, the Council of Netherlands Industrial Federations, the Federation of German Industries and the Association of German Chambers of Industry and Commerce; the Confederation of British Industry; the National Foreign Trade Council, The Business Roundtable, the Emergency Committee for American Trade, the American Petroleum Institute, the Chemical Manufacturers Association, the Financial Executives Institute, the Tax Council, and the California Chamber of Commerce; the Chamber of Commerce of the United States of America, the National Association of Manufacturers, and the United States Council for International Business.

[62] Foreign MNEs filed court cases against the states starting with *Bass, Ratcliff and Gretton, Ltd.* v. *State Commission* in 1924 (lost), *Japan Line Ltd.* v. *Los Angeles* case in 1979 (won), *Barclays Bank Plc* v. *Franchise Tax Board* in 1984 and 1994 (lost), and *Alcan Aluminium and ICI Industries* vs. *Franchise Tax Board* in 1987 (lost). U.S. MNEs also filed court cases against the states: *Exxon Corporation* v. *Wisconsin* and *U.S. Mobil Oil Corp.* v. *Vermont* in 1980 (lost); *Superior Oil Co.* v. *Franchise Tax Board* in 1963, *Honolulu Oil Corp.* v. *Franchise Tax Board* in 1963; *Chicago Bridge & Iron Company* v. *Caterpillar Tractor Company, Illinois Dept. of Revenue* in 1981 (dismissed); and *Container Corporation of America* v. *Franchise Tax Board* in 1983 (lost).

[63] Interview #29.

[64] Ibid.

[65] Interview #32.

[66] The California legislature argued that "the California Legislature holds the express power to enact legislation to impose taxes upon corporations in the State of California pursuant to the California Constitution....Any limitation on the use of worldwide combined reporting to determine taxable income attributable to California would have the effect of circumscribing that power of the California Legislature". Brief of California legislature in the Barclays/Colgate case, January 14, 1994.

[67] For example, in the *Barclays Bank Plc.* v. *California Franchise Tax Board* U.S. Supreme Court case of 1993, amicus curaie briefs in support of the Franchise Tax Board were filed by the California Tax Reform Association and the California Teachers Association; the California Federation of Teachers, the California Faculty Association, the California School Employees Association, the California State Council of Service Employees, the California Professional Firefighters, the American Federation of State, County, and Municipal Employees, the Building and Construction Trades Council of California, the California State Council of Carpenters and the California Public Employees Council; Congressmen Don Edwards, Howard L. Berman and Xavier Becerra; the State of New Mexico and the States of Arkansas, Colorado, Idaho, Maine and Rhode Island; Senators Byron L. Dorgan, Ted Stevens, Frank H. Murkowski, Judd Gregg, and Robert C. Smith; the States of Alaska, Montana, New Hampshire, and Oregon; the Council of State Governments, the National Governors' Association, the U.S. Conference of Mayors, the International City/County Management Association, the National League of Cities, the National Association of Counties, and the National Conference of State

Legislatures; the Multistate Tax Commission; the State of North Dakota and the States of Hawaii and Kansas.

[68] Interview #7.

[69] For example, in the *Barclays Bank Plc.* v. *California Franchise Tax Board* U.S. Supreme Court case of 1993, the United Kingdom and the Member States of the European Communities (Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain and the United Kingdom) and the Governments of Australia, Austria, Canada, Finland, Japan, Norway, Sweden and Switzerland filed amicus curiae briefs in support of the petitioner, Barclays Bank.

[70] Organisation for Economic Cooperation and Development, 1995, III-20.

[71] Keohane and Nye, 1989, p. 11.

[72] World Tax Report, August 27, 1993, first citation.

[73] Interview #39.

[74] Interview #32.

[75] Interviews #4, #8 and #33.

[76] Interviews #23, #3, #42 and #32.

[77] Interviews #23 and #24.

[78] Interview #11.

[79] Interview #32.

[80] Interview #25.

[81] 1965 (HR11798), 1966 (HR16491), 1967 (HR2158 and HR7906), 1969, 1971, 1973, 1976, 1977, 1979, 1981 and 1983.

[82] Interview #10.

[83] Interview #23.

[84] Interview #29, #39 and 24.

[85] California Franchise Tax Board, 1994.

[86] Interview #39.

[87] Interview #29.

[88] Interview #7.

[89] Interview #23.

[90] Interview #25.

Chapter 7: Conclusions

1) A new subfederal bargaining model

The concluding chapter will summarise the findings of the thesis and further explore the implications of applying state-firm bargaining to the subfederal level. It will examine other clashes between U.S. state economic policies and international norms, describe international activism by subfederal jurisdictions in different countries, and discuss the possible implications of new and proposed multilateral agreements on U.S. subfederal economic regulations which violate international norms. It will then speculate on how future conflicts over U.S. state economic policies which violate international norms might best be negotiated.

Through analysis of the debate over California's unitary tax method, this thesis has described newly-evolving modes of state-firm bargaining over U.S. subfederal economic policies. The increase in international economic interactions at the U.S. subfederal level has multiplied the number of international actors which influence U.S. state economic policies, facilitating diverse negotiations over subfederal economic policies which violate international norms. As Hocking demonstrates, multilayered bargaining offers a more dynamic view of foreign policy processes at the subfederal level than traditional models of paradiplomacy. This thesis has expanded the paradiplomacy theories of Hocking, Soldatos, and Duchacek by applying Stopford and Strange's theories of state-firm bargaining to the subfederal level.

The thesis has modeled the bargaining which takes place over U.S. state economic policies that violate international norms by:

1) determining the actors involved in lobbying to change a U.S. state economic policy which violated international norms;

2) *determining the actors' policy agendas;*

3) *determining the different types of assets each actor possessed, and how effectively the actors used these assets to achieve their policy agendas;*

4) *determining how effectively the actors used various channels of negotiation to influence California's policy; and*

5) *determining the most highly effective uses of assets and channels of negotiation, key initiatives which influenced the outcome of the policy debate.*

As stated in Chapter One, this thesis is not attempting to draw general conclusions from one case study as to how international actors influence U.S. state laws which conflict with international norms. The debate over California's unitary tax method is only one example of a U.S. state economic regulation which violated international norms. Nevertheless, it is the most prominent and hard-fought example to date. The California unitary tax debate was the first U.S. state policy issue which had a substantial foreign lobbying presence; forced California to be one of the first states to develop institutions to handle international issues; made foreign governments more aware of the need to act at the U.S. state level; and helped all U.S. states realise they needed to obtain specific exemptions for their laws in emerging multilateral organisations such as the World Trade Organisation if they wished to avoid international conflict over their policies.

2) Hypotheses

The chapters thus far have presented evidence in support of the following hypotheses:

1) **Powerful U.S. states such as California can maintain regulatory standards at odds with federal and international norms.** Growing global economic

interdependence does not eliminate the regulatory options of powerful U.S. states such as California, since the U.S. federal government often refuses to effectively constrain states which violate federal and international norms. Chapter Two demonstrated that U.S. states have been able to maintain formulary apportionment methods of taxing MNEs at odds with the prevailing international norm of the arm's length standard. Chapter Three showed how, under U.S. federalism, the federal government often refuses to rein in U.S. state regulations with international implications. Chapter Four described the political and economic assets which gave California the ability to maintain a regulatory standard at odds with prevailing federal and international norms. Finally, Chapter Six demonstrated that California's growing interdependence with the international economy did not eliminate its regulatory options, since the state was able to effectively bargain to delay a change in its tax method.

2) **U.S. state governments can bargain directly with foreign governments and multinational enterprises as actors in the international arena.** The national government will not always be the preeminent negotiating channel for foreign actors seeking to influence U.S. economic policies. The international arena is increasingly intruding on the affairs of subfederal governments. Chapter Two described the current international regime governing the taxation of MNEs, demonstrating that the debate over California's use of the worldwide combined unitary tax method took place within the context of a larger policy debate between international and national tax authorities over the correct method of taxing the transfer prices of MNEs.

Chapter Three demonstrated that the U.S. national government does not always assert itself as the preeminent negotiating channel for international actors seeking to influence U.S. subfederal regulations, nor is it allowed to by the U.S. judiciary. This permits U.S. state governments to bargain directly with foreign governments and multinational enterprises over their economic policies. Chapter Four described California's extensive economic and cultural links overseas and the evolution of state institutions to implement California's international agenda. Chapter Six demonstrated that during the debate over its unitary tax method, California bargained directly with foreign

governments, foreign-domiciled MNEs and international organisations, as well as with domestic actors such as the U.S. federal government and domestic-domiciled MNEs.

3) The dynamics of U.S. federalism

The increased globalisation of economic activity has led to a greater emphasis on economics in U.S. foreign policy, facilitated more diversity within the formulation of America's foreign policy, and accelerated tensions between the U.S. federal and state governments. "Global interdependence is the primary stimulus to non-central government participation in foreign relations" since the "impact of international economics on the health and well-being of domestic jurisdictions (has) led non-central governments into the foreign policy arena".[1]

When applying state-firm bargaining theory to the subfederal level, it is important to acknowledge the qualities inherent in U.S. federalism which allow U.S. states to bargain directly in the international arena: the power of the U.S. on the world stage, the overlap of authority between the U.S. federal and state governments, and the frequent divergence in the U.S. between what is constitutionally permissible and politically expedient. Although subfederal economic policies which violate international norms would seem natural candidates for traditional channels of diplomatic negotiation, the federalist makeup of the U.S. is exceptional. Under the Tenth Amendment to the U.S. Constitution, states have held that they are not bound by federal laws or international treaties unless it becomes apparent that state laws directly interfere with international commerce or U.S. foreign policy.[2] States therefore view the national government's power to regulate their involvement in foreign affairs as limited to Congress' power to pass federal laws which override explicitly contradictory state laws, and the U.S. judiciary has generally upheld this view.

The U.S. Supreme Court has stated that "federal supremacy is not lightly to be presumed", and has ruled many seemingly contradictory federal laws and policies ambiguous enough to be deemed consistent with state laws.[3] Conflicts between the U.S.

federal and state governments over overtly political issues have a strong history of legal precedents favouring the national government, and future court rulings in this area will likely defer to these precedents. However, "issues with a larger economic content face a more uncertain future in the courts where states have greater legal standing on such issues and precedents appear less clearly applicable to the complexities of interdependent economic processes".[4]

Further, many such intergovernmental conflicts would be dealt with by the U.S. Congress, not the courts. In this forum, a decision in favour of the executive branch of the federal government is "far less certain".[5] The U.S. Congress consists fundamentally of state interests, and is usually reluctant to overrule U.S. state law. Assertions of federal authority over state economic regulations are often viewed with an eye to the political cost of congressional preemption of state authority. The question thus becomes not whether state actions interfere with U.S. foreign economic policy, but whether U.S. foreign economic policy is important enough to override domestic economic and political considerations.

Given the refusal of the federal government to consistently constrain states which violate international norms, the California unitary tax debate demonstrates the importance of the use of multifaceted tactics by international actors engaged in negotiations over U.S. state economic policies. In the case of California's unitary tax, international actors more easily found a political solution at the level of the states, eager to attract and retain investment by U.S. and foreign MNEs, than at the level of the U.S. national government, which did not want to impose a preemptive federal solution.

4) Implications of new multilateral agreements on U.S. subfederal activism

During the debate over California's unitary tax method, the main international organisation dealing with the regulation of taxation, the Organisation for Economic Cooperation and Development (OECD), lacked both an effective enforcement mechanism and direct jurisdiction over subfederal regulations. Therefore, international organisations

were not effective actors during the unitary tax debate. However, the rise of new international trade agreements and institutions, such as the World Trade Organisation (WTO) and the North American Free Trade Agreement (NAFTA), have qualitatively changed the relationship of subfederal governments to international law. These new trade regimes specifically apply to subnational governments, with some exceptions and lesser standards of application; greatly broaden the spectrum of covered economic activity beyond a traditional concern with goods to address services, government procurement, foreign investment, and intellectual property rights, making a large portion of the economies of subfederal government subject to international rules for the first time; and attempt to remove non-tariff barriers to trade (NTBs) by creating a uniform body of international rules on government subsidies, government technical regulations, product and service standards, and health and safety regulations, areas largely under the jurisdiction of states in the U.S.

Although Scheiber and other paradiplomacy theorists predicted the U.S. would bargain away U.S. state powers in order to gain concessions from other countries within multilateral agreements, this has not proved true so far. Instead, the federal government has provided broad exceptions for U.S. state regulations in its accession to new international organisations such as the WTO, leaving open both the possibility of U.S. state deviance from international norms and the necessity of multilayered bargaining by international actors seeking to change U.S. subfederal economic regulations.

a) The World Trade Organisation

While previous GATT dispute panels operated on the principle of 'consensus' whereby a single member could exercise a veto, the arbitration panels of the World Trade Organisation (WTO), formed in 1994, operate on the principle of 'reverse consensus', whereby a veto of an arbitration panel's decision requires unanimous support: they are therefore much more effective. As well, under Article 22:9 of the WTO, dispute resolution procedures are explicitly made applicable to measures taken by "regional or local governments or authorities within the territory of a Member".

In July 1994, 42 U.S. state attorney generals sent a letter to President Clinton expressing serious concerns about the WTO's proposed sovereignty over state regulations. In particular, the states feared the WTO's application of GATT rules of non-discrimination, which, starting in the mid-1980s, had been expanded to address 'de facto' discrimination. GATT panels started to be more strict with countries seeking to exempt trade-restrictive internal regulations from GATT rules of non-discrimination under article XX,[6] which provides exceptions for national measures necessary to protect public morals, human, animal or plant life or health, and artistic or endangered natural resources. More alarmingly, the GATT had ruled in the 1992 'Beer II' dispute between the U.S. and Canada that tax preferences for small businesses, allowable under the U.S. Constitution because they only favoured in-state companies by default, were a violation of the GATT's national treatment clause.[7] To states' rights groups, the "kernel of the court verdict indicated that the mere fact of variation of standards within the United States could constitute a violation of national treatment": this has been "the lead example of the potential implications of WTO rules for federal systems".[8]

In order to mollify state concerns,[9] the U.S. federal government sought to strictly limit the WTO's power over U.S. subfederal law in the U.S. implementing legislation for the Uruguay Round Agreements which created the WTO.[10] This legislation provides that the Uruguay Round Agreements "do not automatically 'preempt' or invalidate state laws that do not conform to the rules set out in those agreements - even if a dispute settlement panel were to find a state measure inconsistent with such an agreement".[11] The implementing legislation also states that the mere fact of variations between U.S. state laws does not constitute a barrier to trade, and that states are not bound to observe the WTO's Dispute Settlement Body rulings under the U.S. Constitution's supremacy clause.[12]

The U.S. Uruguay Round Agreements Act further says that only the U.S. federal government may bring court cases against the states which attempt to declare state law inconsistent with the Uruguay Round Agreements.[13] The 11th Amendment of the U.S. Constitution also provides that foreign citizens and citizens of another state may not sue

American states in federal court unless the state consents or Congress waives state immunity.[14] Finally, provisions were made constraining U.S. federal government lawsuits against the states as a means of enforcing WTO decisions. The federal government bears the burden of proof in such a lawsuit to show that a state law is inconsistent with WTO rules, regardless of the finding of a WTO panel. Notice must be given to Congress prior to filing suit, along with a justification for preempting state law. In the event of an unfavourable judgment, states are protected from retroactive liability.[15]

The United States also secured country-specific reservations in the Agreement on Government Procurement (AGP), which exempted several state procurement preference programs.[16] However, in an effort to make their jurisdictions attractive to international business, 37 U.S. state governors have agreed to bind their states to the AGP.[17] Although state governments are free to choose whether to join the AGP, once they have signed the agreement, they cannot exclude any future state laws from the AGP. However, this issue is partly unresolved since it is unclear whether governors have the power to bind state procurement practices to an international standard without accompanying state legislation.[18]

i) Massachusetts' Burma law

The state of Massachusetts entered into controversy when it passed a June 1996 bill[19] barring state entities from buying goods or services from companies on a state 'restricted purchase list' of firms doing business with Burma.[20] The EU and Japan filed suit against the U.S. under the WTO, claiming the state act violated provisions of the Agreement on Government Procurement, which Massachusetts had agreed to join. In September 1996, three months after the state statute was approved, the U.S. federal government passed its own sanctions act against Burma.[21]

By 1998, members of the National Foreign Trade Council (NFTC), an association representing companies engaged in foreign commerce, were on the Massachusetts restricted purchase list. The NFTC filed a lawsuit claiming the state law was an unconstitutional infringement on the federal government's ability to conduct foreign

affairs, a violation of the foreign commerce clause, and a preemption of federal sanctions against Burma.[22] In order to avoid the gray area of whether it was legal to sue a state, the NFTC sued the Massachusetts official responsible for enforcing the law. The federal district court struck down the Massachusetts statute in November 1998 as an impermissible encroachment on the federal prerogative to conduct foreign policy. The EU and Japan agreed to withdraw their WTO dispute proceedings in light of the district court's ruling.[23] The U.S. Court of Appeals backed the district court's reasoning in June 1999, and further stated that the Massachusetts law discriminated against foreign commerce and, as such, violated the Foreign Commerce Clause of the U.S. Constitution.

The U.S. Supreme Court unanimously ruled in June 2000 that the Massachusetts law, which had more extensive sanctions against Burma than the federal sanctions, contradicted the U.S. federal law and interfered with Congress' specific delegation of discretion to the White House to speak for the U.S. on the matter of sanctions against Burma, violating the principle of federal supremacy.[24] The court explained this decision differed from their ruling in the Barclays case because in that case, Congress had specifically rejected both foreign government objections to a state law, by removing a section of the 1979 U.S.-UK tax treaty prohibiting state use of the worldwide combined unitary method, and U.S. executive branch objections, by refusing to pass federal legislation banning state use of the WWC method introduced by the Reagan administration. However, Congress had passed a specific law regarding sanctions against Burma. Therefore, the Massachusetts law was illegal since it interfered with Congress' foreign policy objectives, as put forward in the federal sanctions act.[25] This decision, and the explicit reference to the Barclays case, further strengthened the role of Congress in determining the role of states in U.S. foreign policy, to the dismay of the U.S. Solicitor General, who argued that Congress should not have to pass a law every time it wanted to pre-empt state action on foreign policy matters, since "sometimes diplomacy is best conducted quietly".[26]

Although seen as a defeat for the states, the Supreme Court did not rule on whether the Massachusetts statute violated the foreign commerce clause by discriminating

between foreign and domestic commerce, explicitly setting this question aside in their decision. The court further set aside the question of whether federal laws are generally presumed to pre-empt state laws on matters of foreign policy. As such, the decision left open the possibility that U.S. states could formulate their own laws regarding foreign policy on a case by case basis. In July 2000, the U.S. District Court ruled that the city of Miami's 1996 law against artists with Cuban connections performing within city limits, which violated a U.S. government law encouraging artistic exchanges with Cuba, was now illegal in the light of the U.S. Supreme Court decision against Massachusetts. However, it remains to be seen whether U.S. state economic sanctions against foreign countries, or other subfederal foreign policy stances, will be ruled illegal if there is no congressional act concerning the issue in question, and several states are preparing test laws on various issues.[27]

Further, the U.S. Court of Appeals stated that "The passage of the Massachusetts Burma Law has resulted in significant attention being brought to the Burmese government's human rights record. Indeed, it may be that the Massachusetts law was a catalyst for federal action", since Massachusetts' congressional representatives[28] played a role in crafting the federal law, which was enacted only three months after the Massachusetts law.[29] Thus, even though the state law was ruled illegal by the courts, it affected the formulation of U.S. foreign policy.

State economic sanctions, such as the Massachusetts Burma law and threatened sanctions against Swiss banks over asset claims by Holocaust survivors and their heirs,[30] are separate from aspects of state government involvement in the international arena examined in the debate over California's unitary tax, in that sanctions are not instances where state governments "seek to promote their jurisdictions' economic welfare, but rather an overlapping subset of issues where economic policy is used to serve more political foreign-policy objectives".[31] Nevertheless, it is useful to examine such cases to gather further information on the actors, negotiating channels, strategies, and legal issues involved in debates over U.S. subfederal economic policies which conflict with international norms.

ii) U.S. state government procurement and labeling

State procurement practices which discriminate against foreign products, particularly "buy domestic" programs and small business set-asides, feature prominently in EU, Canadian, and Japanese complaints about U.S. barriers to trade.[32] Although many U.S. states have acceded to the GATT Agreement on Government Procurement, states have only applied the Agreement to a portion of their procurement practices, and foreign complaints have continued. For example, the European Commission claims California state preferences for small and minority-owned businesses close 20% of the state government market to foreign competition.[33]

Further, foreign governments protest state standard and labeling requirements which are more stringent than U.S. federal law. However, in the *Florida Lime & Avocado Growers, Inc.* v. *Paul* case, the U.S. Supreme Court ruled that a California law prohibiting the importation of avocados which fell below prescribed quality standards was not preempted by federal regulation setting different quality standards because the mere fact of federal regulation did not automatically overrule state regulation unless Congress had specifically declared it preemptive.[34] The court therefore ruled that if the state and federal government concurrently have authority over an area of regulation, U.S. state law is not invalid merely because it is more restrictive than federal law, but only if it directly interferes with a federal law or policy. This leaves open the possibility that U.S. courts would let stand U.S. state standards more stringent than federal regulations despite a negative WTO ruling. At the same time, the WTO has made provisions that member nations are not required to accept lower international standards for food safety or public health, and can require a 'zero risk' standard if they so choose.[35]

b) The proposed Multilateral Agreement on Investment

Member countries of the Organisation for Economic Cooperation and Development's Ministerial Council started negotiating in 1995 for a Multilateral Agreement on Investment (MAI) which would further regulate international investment and trade in services. These efforts were halted in October 1998.[36] However, further

international regulation of services, an area largely governed in the U.S. by the states, may surface again in the form of future international agreements or a strengthening of the WTO.

One of the chief goals of the EU during the MAI negotiations was that the disciplines of the MAI be made applicable to subfederal governments: this chiefly targeted the U.S. states.[37] U.S. states were concerned that the proposed MAI would impact the law-making power of state and local governments in several areas.[38] In particular, a proposal put forward during the negotiations would have required the uniform treatment of foreign investors within national borders, which would have likely conflicted with the ability of laws and regulations to vary among states.[39] In this instance, the GATT Beer II decision was often cited with alarm as demonstrating that the WTO and MAI would find U.S. state laws illegal simply because of their diversity.

Protests by U.S. states over the possible implications of the MAI prompted the U.S. national government to initially propose an exclusion of all U.S. state and local regulation from the scope of any MAI, a "rather breathtaking omission" given the amount of investment and services that U.S. states regulate.[40] The presidential administration worried that unless such concessions were made, the MAI would not be approved by the U.S. Senate.[41] Further, during the negotiations, the U.S. Treasury Department consulted with the states extensively on MAI proposals, particularly, after the California unitary tax debate, on provisions regulating subfederal taxes.

c) The North American Free Trade Agreement

The North American Free Trade Agreement (NAFTA), which went into effect in 1994, has requirements similar to those of the WTO regarding national treatment in procurement, standards, sanity and phytosanitary measures; covers investment and financial services; provides a boarder coverage than the GATT of other service sectors; and contains side agreements on labour and environmental standards. It therefore covers large areas of policy regulated in the U.S. by subfederal governments.

NAFTA gave state and local governments deadlines by which they could exempt some of their activities from coverage under the agreement. However, after those deadlines passed, subfederal governments were forbidden to pass any new measures which discriminated against foreign goods or services.[42] NAFTA further applied the WTO's general exceptions for U.S. state economic regulations to most of its investor protections, and added exceptions for subfederal grant and loan programs, all local government measures, and all existing subfederal tax laws.[43] NAFTA's U.S. implementing legislation likewise provides that only the U.S. federal government may use U.S. courts to bring action against states which pass laws that violate the NAFTA.[44] However, NAFTA's provisions for foreign investment guarantees under Chapter 11 allow MNEs from a NAFTA country to sue the subfederal jurisdictions of any other NAFTA country that imposes laws or regulations which injure the company's property, "including the intangible property of expected profits" .[45] Thus, although NAFTA arbitration panels cannot overturn U.S. state laws, fear of potential damage awards by the panels under this provision may inhibit U.S. states from passing regulations harmful to foreign MNEs.

d) Strategies

Can U.S. states still bargain with international actors and the U.S. federal government under the constraints imposed by these new, more powerful multilateral agreements? In the case of Massachusetts' Burma law, the only action thus far that the WTO has brought against a U.S. state, the WTO action was suspended by the EU, the plaintiff, when the U.S. court system ruled the state action illegal. Past WTO rulings against the U.S. for actions declared legal by the U.S. court system have either been ignored (Beer II and the Tuna-Dolphin case)[46] or suspended following a political negotiation with the offended party (in the case of EU objections to the U.S. Helms-Burton law).[47] It seems likely that strengthened international regimes do not avoid the need for bargaining.

There seem to be several bargaining options in the new environment created by these multilateral agreements:

1) Informal bargaining between the states and the federal government when the U.S. is negotiating for the establishment or extension of a multilateral agreement. Informal bargaining took place during negotiations for the proposed MAI and the NAFTA, and before U.S. implementing legislation for the WTO was presented to Congress. There was a realisation by the U.S. government that these multilateral agreements would not be approved by Congress unless concessions were made to state interests during the negotiations.

2) Informal bargaining between the states and the federal government on a case-by-case basis after an international regime has been established. Although U.S. states do not automatically have to abide by a WTO finding against their laws, the U.S. federal government can ask states to follow a WTO decision in order for the U.S. national government to avoid foreign retaliation or international embarrassment. In return, the national government could promise increased federal aid or action on the issue under contention.

3) The federal government could sue the states for violating an international agreement, demanding payment of damages caused by foreign retaliation against the U.S. authorised under an international agreement against a state action. The U.S. implementing legislation for the WTO and the NAFTA allows the federal government to bring legal action against a state, although the same legislation exempts many state laws which potentially conflict with the rules of multilateral organisations from their organisations' jurisdictions.

Moreover, provisions in the U.S. implementing legislation of the WTO limit the federal government's ability to sue the states to enforce WTO decisions. In particular, requirements that the presidential administration notify Congress prior to filing suit against the states seem to trigger automatic grounds for a successful U.S. Supreme Court appeal by the states if Congress does not then pass a law preempting the state law in question.[48] If Congress does not then pass such a law, the court will most likely not

support the right of the federal government to overrule state laws which conflict with the international obligations of the executive branch.

4) The federal government may decide to sacrifice the damages caused by foreign retaliation authorised under a multilateral agreement against an offending state law; this calculation may depend on the domestic politics surrounding the state policy in question.

5) If the case involves a U.S. state political stance, as it did with Massachusetts' Burma sanctions law, the states may be able to argue that the First Amendment of the U.S. Constitution protects their right to use public procurement protests as a form of free speech, so long as there is not a U.S. federal law on the issue in question.

The legal power of all the states within the U.S. federal system, and the economic and political power in particular of several states, such as California, has allowed the states a great deal of room for bargaining with the U.S. federal government under recent multilateral agreements. The enforcement power of these multilateral agreements on U.S. states is not straight-forward, and states will still be able to bargain with the U.S. federal government and international actors to attempt to avoid multilateral punishment or gain some form of compensation for compliance. Multiple actors and negotiating channels will still be called into play.

5) Subfederal activism in other countries

U.S. states have a great deal of latitude compared to subfederal jurisdictions in other countries. The U.S. federal government often gives state governments free rein in formulating economic policies which conflict with national government policies, and U.S. states have relatively large economies on an international scale. At the same time, the economic and military status of the U.S. on the world stage gives the U.S. less reason than other countries to resolve internal tangles on federalist issues. The bargaining power of several U.S. states, such as California, is therefore quite high.

However, paradiplomacy by subfederal jurisdictions takes place in other countries besides the U.S. (see Box 5 below). It is explicitly constitutional for Swiss cantons and German and Austrian Länder to have substantial autonomy when interacting with the international arena and for French and Belgium subunits to develop their own trans-sovereign contacts; Canadian provinces and the Australian states are implicitly allowed this freedom as well.[49]

Box 5: Subfederal jurisdictions with the legal ability to act in the international arena

Swiss Cantons
German Länder
Austrian Länder
Belgium communal and regional subunits
French régions and départments
Canadian provinces
Australian states

The 1848 Swiss Constitution authorises the border cantons to enter into direct negotiations with their neighbouring counterparts, regional subnational authorities, in minor matters which do not affect federal responsibility.[50] The German Constitution gives major responsibilities to the Länder for the execution of national legislation.[51]

In addition, Article 32, Section 3 of the German Constitution states: "Insofar as the Länder have power to legislate, they may, with the consent of the Federal Government, conclude treaties with foreign states".[52] The Länder have reserved powers in education and culture, although these are legally fairly strictly defined areas.[53] However, these reserved powers can still hold sway on international issues. In 1957, the German government challenged Lower Saxony legislation establishing a nondenominational school system for all children, on the grounds that the German-Vatican Concordat of 1933 constitutionally guaranteed Catholic students separate schools. Although the court

accepted the treaty, it stated that the "treaty power of the national government could not extend to an infringement of the reserved power of the Länder in the field of education" and let the Länder legislation stand.[54]

The Austrian Constitution requires that the federal government consult with the Länder before concluding treaties which could affect their regional jurisdiction.[55] In France, the régions and their départements have begun developing their own trans-sovereign contacts: since 1983, their initiatives have been centrally coordinated by means of an office established as an adjunct to the Secretary General of the French Ministry of Foreign Affairs: "Délégué pour l'Action extérieure des Collectivités locales".[56] This office seeks to ensure that the initiatives of towns, départements and régions do not interfere with the foreign policy of France.[57]

The 1970 Belgian Constitution granted the communal and regional subunits of Belgium the right to engage in international contacts, albeit limited to such issues as health, culture, and education.[58] Both the Flemish and Walloon communities have established their own foreign offices, and there are permanent missions of Wallonia-Brussels in Paris, Quebec and Geneva, and Wallonia-Brussels cultural centers in Paris and Kinshasa, Zaire; the Flemish community has a cultural center in Amsterdam.[59]

Canada exists as a confederation, which leaves open the possibility of serious provincial policy involvement in foreign affairs. The power of the Canadian central government to legislate the implementation of treaties is in question, since no constitutional supremacy clause exists to automatically give precedence to the central government in conflicts between national and provincial legislation. However, since all political powers are considered exclusive and belong either to the national or provincial governments, the actual incidence of jurisdictional conflict is low.[60]

Canadian provinces are quite active in international relations. The Canadian province of Quebec is a prominent player in international diplomacy, and had permanent delegations in Paris and missions in Texas, Louisiana, and California before most were

closed recently.[61] In 1984, Quebec established a Department of External Trade and reorganised its Department of Intergovernmental Affairs into a Department of International Relations.[62] Other Canadian provinces followed Quebec's lead by developing large-scale bureaucracies to pursue international affairs and permanent overseas offices: Alberta has a Permanent Mission in New York City; Ontario had missions in Paris, London and Brussels, although many of these have been closed recently.[63] Alberta also has an international relations divisions within its ministry of intergovernmental affairs and, along with Quebec, a significant trade ministry.[64]

Australian federalism is weak compared to that of the U.S. or Canada.[65] The Australian Senate is a party-based chamber which only rarely serves the interest of the states.[66] Australia has broad areas of concurrent jurisdiction in the distribution of powers between its federal and subfederal levels, and a constitutional clause grants supremacy to the national government in areas of disagreement. Further, both Canadian and Australian political parties are split between the national and subnational levels, so separate policy issues can more easily evolve at the subfederal level.[67]

Of course, the stated framework of federal power-sharing may differ markedly in practice. The Soviet Constitution of 1944 declared that "each Union Republic has the right to enter into direct relations with foreign States and conclude agreements with foreign States and exchange Representatives with them. Each Union Republic has its own Republican military formations".[68] Evidently, there is a difference between legal federalism and actual political control.

In India, many states have been going abroad to encourage international trade and investment within their jurisdictions: Andhra Pradesh's Prime Minister is particularly active on the international stage. However, the Indian Constitution is very clear that all foreign relations, including foreign commercial relations, are to be handled by the central federal government, so subfederal dealings with foreign governments or international organisations are forbidden. The World Bank may deal directly with state governments; however, this is done with the knowledge, agreement and permission of the central

government, which usually signs a Memorandum of Understanding first with the World Bank that sets out an agreed programme. There is a move to allow Indian states to borrow abroad, but, under the Indian Constitution, all debt liabilities for the country are automatically assumed by the central government. If the states start borrowing abroad, they would be incurring liabilities for the central government: therefore, such external borrowing is currently not allowed.

Subnational governments in Latin America saw a rise in incipient economic foreign activity during the 1980s, when central governments in this region began to view subfederal economic paradiplomatic activities as valuable instruments to promote economic integration, development, and regional cooperation.[69] Although the capability for subfederal units in Latin America to act abroad is restricted in regimes whose regulatory capacity has been eroded by drug trafficking or guerrilla warfare, states such as Argentina, Brazil and Uruguay, which have seen recent periods of political and institutional stability, have seen a concurrent strengthening of subnational autonomy.[70]

Under Brazil's constitution, its individual states have a great deal of scope to influence macroeconomic policies; by the early 1990s, virtually every state in Brazil had at least one autonomous state bank, and neither the federal government nor the Central Bank had authoritative control over these banks' international borrowing activities: the state banks could effectively print their own money by issuing huge bond offerings.[71] By the mid-1990s, the impending bankruptcy crisis of virtually all of the state banks had forced the federal government to become the liquidator of last resort. However, the Brazilian states still maintain the power to tax exports and to negotiate, with national Senate approval, international agreements. Further, the new Brazilian Constitution of 1988 is not overly concerned with the supremacy of federal law over state law, and allows Brazilian states to maintain their own military police forces.[72]

The European Union's recent emphasis on the concept of 'subsidiarity' is another route to potential 'subfederal' activism. Under the 1992 Maastricht Treaty on European Union, subsidiarity applies in areas of concurrent competence between the EU and the

member states, and provides that "the Community shall take action, in accordance with the principle of subsidiarity, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the member states and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the community".[73] However, the concept of subsidiarity has not been widely applied by the European Commission, since it is not clearly determined which competences have been assigned to the EU. Therefore, "the question of what is a concurrent power is essentially a political decision of the European Council".[74] Further, the principle of subsidiarity is essentially contrary to the idea of a federal system, where both the national and subfederal government have limited powers: instead, the EU presumes that power is centralised and is being given to subfederal units when it is judged proper by the 'national' European government.

The transfer of regional aid to subnational European governments follows this model by granting money to regions and cities, which, as a result, have set up lobbying offices in Brussels. However, the significant amount of EU regional aid dispersed has also given impetus to European regional and city activism and allowed subnational governments in the EU to gain an economic power base independent of their national governments. This has led to movement towards an enfranchisement of regional European governments. Thus, both the principle of subsidiary and the growth of regional aid have weakened the power of the EU national governments.

When examining conflicts over subfederal economic regulations with international implications, it is important to assess the resources of the actors involved. The resources each subfederal actor can deploy depend not only on its own political and economic power, but on the federal structure it belongs to, the relative power of its subfederal jurisdiction within the country's political structure, and the relative power of its country within the international system. The international activity of non-central governments frequently depends on "the character and traditions of the federal system and the attitudes that these produce".[75] It is therefore necessary, as this thesis has done, to examine the relative freedom subfederal jurisdictions have within their country's political structure and the different channels of influence subfederal governments have on national

government policy. Federalism scholars have done extensive work exploring the framework of power within various federal systems, providing a solid base for future exploration of possible subfederal activism by International Relations theorists.[76]

This thesis has concentrated on the dynamics of negotiations involving U.S. states.[77] However, other subfederal countries or confederations may provide fertile ground for future research. It may be particularly interesting to examine a country such as China, whose activist provinces are increasingly involved in the regulation of economic international activity at a time when the Chinese national government is attempting to impose a new economic regulatory framework on the country as it joins the WTO.

6) Towards a new model of regulation

This thesis expands the field of paradiplomacy by modeling negotiations over U.S. subfederal economic regulations with international implications, and expands the base of state-firm bargaining theory by applying it to the subfederal level. The thesis has examined a prominent case of negotiations over a subfederal economic policy which violated international norms, and analysed how effectively the actors used various assets and channels of negotiation to achieve their agendas in the debate. Examining bargaining at the subfederal level will become increasingly important as the growth of both international economic activity at the U.S. subfederal level and multilateral agreements governing policy areas traditionally regulated by U.S. states increases the incidence of conflict over U.S. state regulations which violate international norms.

In the case of California's unitary tax, the state's power to defend its regulations against the U.S. federal government, MNEs, and foreign governments waned as its growing dependence on the world economy constrained its policy options. Although the state had unusually strong resources for a subfederal unit, California modified its tax method to accord with international norms in order to remain an attractive destination for international trade and investment. California made the same calculations as countless nations before it, and decided that a short-term revenue loss from changing its regulations

would be outweighed by long-term gains from joining the world trading order. However, the state had enough power to modify its regulations in the manner most advantageous to it: initially, California maintained the right to overturn a company's decision to file under the ALS method and charged a fee for companies which did so; in 1993, despite eliminating these restrictions, California maintained the principle that the state could apply the unitary tax method, avoiding the payment of back taxes under a legal decision at a time when the state was suffering financially.

Kline points out that while U.S. states are not required to adhere to the new GATT government procurement code, they often do so anyway in order to gain market access for the firms. Increasingly, U.S. states may realise, as national governments have done, that it is in their own broad self-interest to adhere to international agreements and maintain credibility in the international arena.[78]

Kincaid asserts that since U.S. subfederal involvement in foreign affairs is so new, diverse, and dynamic, one should be cautious about trying to impose overly rational or tightly demarcated organisational structures or regulations on this nascent activity. Instead, he suggests an informal development of "soft law" rules of the game. As such, actors can "avoid clashes over the application of 'hard law' regulations that force federalism players into conflictual zero-sum solutions. This concept accords with Hocking's view that federal systems are 'an amalgam of constitutional norms, judicial interpretation and pragmatic political considerations'" which favour informal behavioural norms to regulate the encroachment of these systems in the international arena.[79] Kline agrees that "improved foreign policy management in this milieu is more likely to arise from practiced patterns of cooperative involvement than from the assertion of constitutional constraints or the premature institutionalization of intergovernmental consultations".[80]

The multilayered bargaining taking place over U.S. subfederal economic regulations demands new responsibilities from its participants. As subfederal governments increasingly locate themselves within the U.S. foreign policy process, the

U.S. federal government must continue to involve U.S. states in the formulation and implementation of international agreements which impact state law, avoiding the potential for conflict.[81]

At the same time, foreign actors are realising that in order to achieve certain policy objectives in the U.S., the American system of federalism often necessitates that they negotiate directly with U.S. state governments over subfederal regulations.[82] In this environment, increased knowledge of state government policymaking and a strengthening of regular contacts with subfederal actors will provide a firm basis to resolve conflicts stemming from foreign investment and trade within the U.S.

Further, U.S. states must go beyond overseas offices and an attitude of entitlement over their policymaking power within the U.S. federalist system to develop their knowledge of international policies and institutions.[83] As international economic activity increasingly affects U.S. state jurisdictions, their need to understand and communicate with international actors on the implications of state regulations has become urgent. U.S. states which are becoming increasingly integrated with the world economy will need to accelerate their relations with foreign governments. State policymakers will increasingly have to take into account the potential affect of deviations from international norms as they seek to ensure their policy environments promote international trade and investment which benefits the state economy.[84] Regulations which violate international norms may result in state businesses being discriminated against overseas or in a withdrawal of foreign trade and investment from the state.[85]

How can international actors effectively influence U.S. state economic policies which conflict with international norms? The debate over California's unitary tax indicates that actors engaged in negotiations over U.S. state economic policies which violate international norms are effective when they employ many different types of assets and channels of negotiation in order to achieve their objectives. The nature of U.S. federalism does not allow for the straightforward imposition of international or U.S. federal law on U.S. state economies. Instead, bargaining will take place.

[1] Hocking, 1993, p. 107.
[2] Interview #10.
[3] 1952 ruling, *Schwartz* v. *Texas*. Shuman, 1992, p. 164.
[4] Hocking, 1993, p. 116.
[5] Ibid.
[6] State laws which potentially conflict with WTO rules include regulations on food quality, labeling, inspection and pesticides; consumer protection; pollution abatement and the handling of toxic materials; business development and preferences for in-state business; transportation; energy conservation, product packaging, recycled content, and wildlife conservation. In all of these areas, many U.S. state laws differ from state to state, and are frequently more restrictive than U.S. federal law. Maruyama, 1998.
[7] See Appendix 9 for a description of the Beer II decision.
[8] Murayama, 1998.
[9] The National Conference of State Legislatures claimed the states were not prepared to accept the "challenge to their sovereignty" of an "arbitrary and unreasonable standard of discrimination against foreign commerce, similar to that employed by the GATT panel in the so-called Beer II decision...The states contended that the GATT panel report fail(ed) 'to acknowledge the sovereign right of states in a federal system to establish different, but non-discriminatory laws that reflect local conditions that do not necessarily pertain in all states'". Brief of the Council of State Governments et al, in the Barclays/Colgate Case, 1994.
[10] The states were concerned over the adequate representation of their rights by the U.S. federal government before the WTO's Dispute Settlement Bodies (DSBs), since only signatories to the WTO, the national governments, were guaranteed standing before the DSBs. States worried that the DSBs would not regard states' rights as inherently good or counterbalancing factors when examining trade disputes, as the U.S. federal court system presumably did. Further, they feared that since the U.S. as a whole would suffer the consequences of WTO-sanctioned foreign retaliation over an offending U.S. state law, the federal government might be induced to pass federal legislation overriding offending state laws.
[11] Note 42, at 14 in the Uruguay Round Agreements Act. Brief of the Council of State Governments et al, in the Barclays/Colgate case, 1994.
[12] As well, provisions are made in the implementing legislation for a system of federal-state consultation and cooperation, including definite time tables for notifying states when their laws are subject to challenge in WTO proceedings or when U.S. challenges to foreign practices may prompt retaliation against the states. Brief of the Council of State Governments et al, in the Barclays/Colgate case, 1994.
[13] 102(b)(2). Brief of the Council of State Governments et al, in the Barclays/Colgate case, 1994.
[14] Ibid.
[15] Walter Hellerstein, 1995, p. 3.

[16] Western Governors' Association, 1997, p. 20. These cover procurement preferences promoting business development by minorities, women and veterans; development of distressed areas; and environmental quality. Individual states were allowed to apply the AGP only to as much of their procurement as they desired, and many states list their own reservations to the AGP, including Hawaii, Kansas, South Dakota and Washington.
[17] Western Governors' Association, 1997, p. 20.
[18] Kline, 1999, p. 113.
[19] "An Act Regulating State Contracts with Companies Doing Business with or in Burma (Myanmar)", 1996 Mass. Acts 239, ch. 130 (codified as Mass. Gen Laws 7:22G-7:22M, 40 F1/2 [1997]).
[20] Supreme Court of the United States, 2000.
[21] Foreign Operations, Export Financing, and Related Programs Appropriations Act, 1997, 570, 110 Stat. 3009-166 to 3009-167 (enacted by the Omnibus Consolidated Appropriations Act, 1997, 101[c], 100 Stat. 3009-121 to 30009-171). Supreme Court of the United States, 2000.
[22] Supreme Court of the United States, 2000.
[23] Lundby, 1999; the dispute proceedings then automatically lapsed, but the parties were not barred from reinstating WTO procedures to challenge the state act in the future. Supreme Court of the United States, 2000.
[24] Greenburg, 2000.
[25] Supreme Court of the United States, 2000.
[26] Mauro, 2000, p. 4.
[27] See Appendix 4 for a list of U.S. state and local economic sanctions against foreign countries on human rights grounds.
[28] Massachusetts Congressmen Denning and McCall.
[29] Supreme Court of the United States, 2000.
[30] See Appendix 15.
[31] Kline, 1999, p. 113.
[32] European Commission, *Report on United States Barriers to Trade and Investment* (Brussels 1994) 36-37; Canada, Department of Foreign Affairs and International Trade, *Register of United States Barriers to Trade* (Ottawa 1996) 13; Japan, Subcommittee on Unfair Trade Policies and Measures, Industrial Structure Council, *Report on Unfair Trade Policies* (Tokyo 1994) 19.
[33] European Commission 1994 at 56. Stumberg, 1994, p. 22. The European Commission has also warned that state labeling requirements which differ from international standards "would have serious negative consequences on EU/US trade in foodstuffs" and singled out California's Safe Drinking Water and Toxic Enforcement Act as a burden on EU producers. (European Commission 1994 at 81 and 56. Stumberg, 1994, p. 19). The Commission identified California regulations on the presence of lead in ceramicware, tableware and wine as a barrier to trade (European Commission 1994 at 56. Stumberg, 1994, p. 21) and complained that California's stringent laws on pesticide residue levels have resulted in "unduly delayed approval procedures" which have disrupted trade. (European Commission at 77. Stumberg, 194, p. 19).
[34] Maier, 1989, p. 833.

[35] Maruyama, 1998. The Sanity and Phyotsanitary Measures (SPS) Agreement of the WTO insists that national exceptions to GATT rules made on health grounds under article XX should be based on a "risk assessment and an objective relationship to sound science...Article 3.3, however, explicitly reaffirms the right of governments to promulgate standards that result in a higher level of S&P protection...(it) further clarified that a standard shall not be deemed inconsistent with SPS obligations merely because it results in a different level of protection than an international standard".
[36] The attempt to form an MAI was disrupted by non-governmental organisation protests for human rights, environmental and cultural protection, similar to those which sank the 1999 Seattle meetings of the WTO. Since the MAI was "little-known outside the OECD" and "the range of topics for negotiation proved too wide, and the initial goals too ambitious", member countries felt little need to press forward with the plan once objections were raised. Henderson, 1999, p. 38.
[37] Henderson, 1999, p. 38.
[38] These include: limits on state policies favouring local businesses, including direct state subsidies, state government actions as a market participant, and laws where state interests outweigh incidental effects on out-of-state commerce; limits on state investment incentives for economic development, pollution prevention, and recycling; limits on performance requirements that hold companies accountable for creating jobs or making certain investments if they receive state government assistance; limits on economic, land use, and environmental regulation, if MAI arbitration forums found that those laws were burdensome enough to constitute an expropriation of company property; enforcement proposals that would enable investors or their home governments to seek remedies directly against state laws through international arbitration or domestic courts; and limits on general exceptions and country-specific reservations to the MAI that could bring many more state practices within the scope of the MAI than had been covered under previous international trade liberalisations. Western Governors' Association, 1997, p. iii.
[39] Western Governors' Association, 1997, p 5.
[40] Interview #17.
[41] Ibid.
[42] Weiler, 1996, p. 3.
[43] Western Governors' Association, 1997, p. 6.
[44] Ibid., p. 21.
[45] Greider, 2001, p. 21.
[46] The GATT panel ruled in 1992 that certain provisions of the U.S. Marine Environmental Protection Act (MMPA) were illegal. Because of the pending NAFTA agreement, Mexico did not seek the approval of the panel decision by the GATT Council that would have been necessary to permit retaliation against the United States. However, in June 1994, another GATT dispute panel ruled in a case brought by the EC that the secondary embargo provisions of the Marine Mammal Protection Act also were contrary to GATT. Unlike Mexico, the EEC sought to gain approval of the decision which has been blocked from GATT Council review by the United States through the U.S. Trade Representative since the GATT did not have automatic force of law in the U.S. The WTO carried over all of the GATT's pending dispute panels, but the Tuna/Dolphin report was never adopted, as the Clinton administration amended the MMPA to implement the

GATT ruling after threats of a WTO enforcement case. Walsh, 1995, p. B6; Wallach, 1999; Maruyama, 1998.

[47] The EU requested the formation of a panel to consider the compatibility of Helms-Burton with WTO commitments, but suspended proceedings for a year to allow bilateral negotiations to proceed. The U.S. had threatened to boycott the WTO proceedings on this issue. An agreement between the U.S. and the EU over the issue was reached in May 1998 where the U.S. "agreed to waive sanctions against the companies engaged in the Iranian pipeline transactions, to continue the waiver of private suits under Title III of the Helms-Burton Act, and to seek to waive authority under Title IV of the Act....In return, the European Union agreed to a series of 'disciplines' that ban investment in any illegally expropriated property in the future and set up a claims registry on which claimants who contend that their property has been expropriated can file a claim. The EU also agreed to forestall any WTO action. At the end of 199(9), however, the agreement remained precarious and had yet to be implemented. Congress has not acted on the necessary amendment to Title IV of Helms-Burton and there is continuing disagreement on the interpretation of the EU disciplines agreement". McGlone and Trenkle, 1999; Wallach, 1999.

[48] Interview #11.

[49] Duchacek, 1988, p. 6.

[50] Ibid., p. 13.

[51] Cerny, 1968, p. 157.

[52] Duchacek, 1987, p. 215.

[53] Cerny, 1968, p. 163.

[54] Ibid., p. 162.

[55] Duchacek, 1984, p. 28.

[56] Established by a circular letter from the French Prime Minister on May 26, 1983.

[57] Duchacek, 1988, p. 25.

[58] In an August 8, 1980 law on institutional reforms in Belgium, Article 81 states that for "matters that are within the jurisdictional realm of the community, the executive of that Community...is to participate in international negotiations dealing with these matters". In addition, both Belgian Régions and Communities participate at the weekly meetings of the Central Ministry of Foreign Affairs that are concerned with the EC. The Belgian King clearly remains the international negotiator only in matters of peace, alliance, and commerce treaties. However, Article 15 states "The Belgian State does not guarantee obligations accepted by the Communities or Régions". Beaufays, 1988, p. 47.

[59] Beaufays, 1988, p. 49.

[60] Livingston, 1968, p. 106.

[61] Keating, 1999, p. 13.

[62] Duchacek, 1988, p. 40.

[63] Duchacek, 1988, p. 13; Keating, 1999, p. 13.

[64] Feldman and Feldman, 1988, p. 72.

[65] Cerny, 1968, p. 111.

[66] Ibid.

[67] Ibid., p. 106.

[68] Articles 18a and 18b. Duchacek, 1987, p. 207.

[69] Cornago, 1999, p. 49.
[70] Ibid., p. 49.
[71] Stepan, 2000, p. 154.
[72] Ibid., p. 159, p. 163.
[73] Treaty on European Union, Art. 3b. Weiler, 1996, p. 22.
[74] Weiler, 1996, p. 23.
[75] Hocking, 1993, p. 85.
[76] Bakvis and Chandler, Duchacek, and Hocking, among others.
[77] Other studies of paradiplomacy include: John M. Kline, State Government Influence in U.S. International Economic Policy (Lexington, MA: Lexington Books, 1983); Douglas M. Brown and Earl H. Fry, eds., States and Provinces in the International Economy (Berkeley: University of California Institute of Governmental Studies Press, 1993); Earl H. Fry, The Expanding Role of State and Local Governments in U.S. Foreign Affairs (New York: Council on Foreign Relations Press, 1998); Francisco Aldecoa and Michael Keating, eds., Paradiplomacy in Action. The Foreign Relations of Subnational Governments. (Frank Cass & Co. Ltd.: Portland, Oregon, 1999); Brian Hocking, ed., Foreign Relations and Federal States (London: Leicester University Press, 1993); Hans J. Michelmann and Panayotis Soldatos, eds., Federalism and International Relations: The Role of Subnational Units (Oxford: Clarendon Press, 1990); Ivo D. Duchacek, ed., "Federated States and International Relations", Publius: The Journal of Federalism , Vol. 14 (Fall 1984).
[78] Kline, 1983, p. 216.
[79] Kline, 1999, p. 137.
[80] Ibid., p. 138.
[81] Interview #17.
[82] Interview #18.
[83] Interview #25.
[84] Interview #10.
[85] Interview #3.

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Appendix 1: States Adopting UDIPTA, Multistate Tax Commission Regulations, and the Multistate Tax Compact

State	Adoption of UDIPTA	Adoption of MTC Regulations	Membership in Multistate Tax Compact
Alabama	Yes	Substantially all	Yes
Alaska	Yes	Substantially all	Yes
Arizona	Yes	Substantially all	No
Arkansas	Yes	Small number	Yes
California	Yes	Substantially all	Yes
Colorado	Yes, option to apply	Substantially all	Yes
	UDIPTA provisions or		
	state's significantly		
	different provisions		
Connecticut	No, but similar statute	None	No
Delaware	No, but similar statute	None	No
District of	No, but substantially	None	Yes
Columbia	similar provisions		
Florida	Yes	Most	No
Georgia	No, but many similar	None, but several	No
	provisions	similar provisions	
Hawaii	Yes, but option to apply	Substantially all	Yes
	state's alternative and		
	significantly different		
	provisions to non-		
	business income		
Idaho	Yes	All except one on airlines	Yes
Illinois	Yes	Many	No
Indiana	No, but many identical	Many generally	No
	provisions to non-	consistent provisions	
Iowa	No, but statute with	Only a few	No
	some of same features		
Kansas	Yes	Most	Yes
Kentucky	Yes, with many	Generally	No
	variations	consistent provisions	
Louisiana	No, but some similar	None	No
	provisions		

State	Adoption of UDIPTA	Adoption of MTC Regs	Membership in Multistate Tax Compact
Maine	Yes, but allocation provisions deleted	Abbreviated version	No
Maryland	No, but similar apportionment factor rules	None	No
Massachusetts	Yes, but some changes	None	No
Michigan	Yes, but similar apportionment provisions	None	Yes
Minnesota	No	Most	Yes, but no UDIPTA option
Mississippi	No	None	No
Missouri	Yes, option to apply state's one-factor formula or separate accounting	Substantially all	Yes
Montana	Yes	Substantially all	Yes
Nebraksa	No, but several provisions identical	MTC apportionment factor regulations adopted	No
New Hampshire	No, but similar treatment of business income	None, but similar apportionment formula	No
New Jersey	No, but similar apportionment rules	None, but rules that follow general pattern	No
New Mexico	Yes	Substantially all	Yes
New York	No, but some similar provisions	None, but several comparable regulations	No
New York City	No, but substantially similar apportionment formula	None	No
North Carolina	No, but substantially similar provisions	None	No
North Dakota	Yes	Substantially all	Yes

State	Adoption of UDIPTA	Adoption of MTC Regs	Membership in Multistate Tax Compact
Ohio	No, but similar provisions	None, but similar rule for	No
		determining sales factor	
Oklahoma	No, but some	None	No
	apportionment factors		
	taken from UDIPTA		
Oregon	Yes	Substantially all	Yes
Pennsylvania	Yes, but some significant	None, but generally	No
	changes	consistent regulations	
Rhode Island	No, but somewhat	None	No
	similar provisions		
South Carolina	No, but somewhat	None	No
	similar provisions		
South Dakota	No, but many similar	No	Yes
	provisions		
Tennessee	Yes	Most	No
Texas	No, but some features	No	Yes
	followed		
Utah	Yes	Most	Yes
Vermont	No, but some features	None, but some similar	No
	followed	regulations	
Virginia	No, but substantially	None, but several	No
	similar apportionment	comparable regulations	
	provisions		
West Virginia	No	Some, but with	No
		significant differences	
Wisconsin	Yes, many same or	Some	No
	similar provisions		

Source: "State and Local Taxation, Cases and Materials". Jerome R. and Walter Hellerstein. Sixth Edition, American Casebook Series, West Publishing Co., St. Paul, Minn., 1997, Sixth Edition, p. 567. The authors note the table is based on [1] Multistate Corporate Income Tax Guide (CCH) para. 145 (1997) and is used with the permission of Commerce Clearing House, Inc.

Appendix 2: States Imposing the Worldwide Combined Unitary Tax Method

(at the time of the formation of the Worldwide Unitary Taxation Working Group in September of 1983)

Alaska
California
Colorado
Florida
Idaho
Indiana
Massachusetts
Montana
New Hampshire
North Dakota
Oregon
Utah

States Which Subsequently Repealed The Worldwide Combined Reporting System

California	Substantially revised in 1986 and again in 1993.
Colorado	Legislature overrode Governor's veto of unitary reform on June 12, 1985
Florida	Repealed December 20, 1984
Idaho	Changed to water's edge election on January 1, 1988.
Indiana	Repudiated by Governor Orr on February 23, 1984
Massachusetts	Massachusetts Supreme Judicial Court ruled against the state's practice on December 11, 1984
Montana	Repealed 1987
New Hampshire	Repealed 1986
North Dakota	Repealed 1987
Oregon	Repealed August 15, 1984
Utah	Repealed 1987

Appendix 3: Potential Impact of Uruguay Round on California Laws

State law provisions	Cite	Potential conflict
		with GATT
A. Agriculture and Food		
1. Commercial Quality		
Food quality - standards for	Cal. Food Agric. Code	Science, SPS art. 2.2;
fruits, nuts and vegetables	42681 et seq.	Risk assmt., SPS art. 5.1-5.8;
		Unneces. obstacle, TBT 2.2.
Food quality - standard for	3. Cal. Admin. Code	Science, SPS art. 2.2;
grape products	1436	Risk assmt., SPS art. 5.1-5.8;
		Unneces. obstacle, TBT 2.2.
Fertilizer control - registration	Cal. Food & Agri. Code	Science, SPS art. 2.2;
and labeling of fertilizer prior to sale	14561 et seq.	Risk assmt., SPS art. 5.1-5.8.
Seed testing, registration	Cal Food & Agri. Code	Science, SPS art. 2.2;
and labeling	Ch. 2	Risk assmt., SPS art. 5.1-5.8;
		Natl. treatment, art. III; TBT 2.1.
Classification of milk	Cal. Food & Agric. Code	Science, SPS art. 2.2;
	Ch. 3	Risk assmt., SPS art. 5.1-5.8.
Meat quality - types of	Cal. Food & Agric. Code	Science, SPS art. 2.2;
adulteration prohibited	18758	Risk assmt., SPS art. 5.1-5.8.
	Cal. Health & Safety Code	
	26531	
Domestic production - user	Cal. Food & Agric. Code	National treatment. Art. III; TBT 2.1;
citrus processing facilities	63124	Unnecess. obstacle, TBT art. 2.2;
		Science, SPS art. 2.2;
		Risk assmt., SPS art. 5.1-5.8.
Registration and licensing to	Cal. Food & Agric. Code	Science, SPS art. 2.2;
deal in agricultural products	55481, 55521	Risk assmt., SPS art. 5.1-5.8;
		Unnecess. obstacle, TBT art. 2.2.
Coloring - prohibited in the	Cal. Health & Safety Code	Science, SPS art. 2.2;
manufacture or blending of olive oil.	28481	Risk assmt. SPS art. 5.1-5.8.
Dairy quality - milk fat testers	Cal. Food & Agric. Code Ch. 12,	Science, SPS art. 2.2;
regulations	35161 et seq.	Risk assmt. SPS art. 5.1-5.8;
		Unnecess. obstacle, TBT art. 2.2
Reduced fat cheese - standards	Cal. Food & Agric. Code	Science, SPS art. 2.2;
and requirements	37982 et seq.	Risk assmt. SPS art. 5.1-5.8;
		Unnecess. obstacle, TBT art. 2.1
		Equivalence SPS art. 4.1.

State law provisions	Cite	Potential conflict
		with GATT
Adulterants of commercial feed	Cal. Food & Agric. Code	Science, SPS art. 2.2;
	15041	Risk assmt. SPS art. 5.1-5.8.
2. Food Labeling		
Safe drinking water and toxic enforcement -	Cal. Health & Safety Code	Science, SPS art. 2.2;
warning of risk of birth defects	25249.5 (Proposition 65)	Risk assmt., SPS art. 5.1-5.8;
		Unnecess. obstacle, TBT 2.2.
Food labeling - canned	Cal. Health & Safety Code	Science, SPS art. 2.2;
citrus products	26559	Risk assmt., SPS art. 5.1-5.8;
		Unnecess. obstacle, TBT 2.2.
Labeling & standards – frozen dairy products	Cal. Food & Agric. Code Part III,	Science, SPS art. 2.2;
	Ch. 503	Risk assmt., SPS art. 5.1-5.8.
Labeling - concealment of inferiority	Cal. Health & Safety Code	Science, SPS art. 2.2;
	26528	Risk assmt., SPS art. 5.1-5.8.
Organic marketing standards -	Cal. Health & Safety Code	Science, SPS art. 2.2;
certification of organic foods	26569.3	Risk assmt., SPS art. 5.1-5.8.
3. Inspection and Food Safety		
Sanitation standards - definition	Cal. Food & Agric. Code	Science, SPS art. 2.2;
of adulteration of food	41361	Risk assmt., SPS art. 5.1-5.8.
	Cal. Penal Code 383.	
Shellfish-processing	Cal. Health & Safety Code	Science, SPS Art. 2.2;
and transportation	28503	Risk assmt., SPS art. 5.1-5.8.
4. Pesticides and Food Safety		
Pesticide control – prohibited acts	Cal. Food & Agric. Code	Science, SPS art. 2.2;
	12115.3, 12561, 12671, 12812	Risk assmt., SPS art. 5.1-5.8.
Birth defect prevention – pesticide	Cal. Food & Agric. Code	Science, SPS art. 2.2;
active ingredients identification	13127	Risk assmt., SPS art. 5.1-5.8.
Economic poisons -	Cal. Food & Agric. Code	Science, SPS art. 2.2;
classification and labeling	Division VII, Ch.2	Risk assmt., SPS art. 5.1-5.8.
requirements for sale and		
registration		

State law provisions	**Cite**	**Potential conflict**
		with GATT
B. Consumer Protection		
Short weighing - true quantity	Cal. Bus. & Prof. Code 12024	Equivalence, TBT art. 2.7.
represented for commodities		
C. Environmental Health		
1. Pollution Abatement		
Clean air - auto emission	Cal. Vehicle Code 27153 et seq.	Unnecess. obstacle, TBT art. 2.2;
standards		Science, SPS art. 2.2;
		Risk assmt., SPS art. 5.1-5.8.
Reimbursement for pollution abatement	Cal. Health & Safety Code	Natl. treatment, art. III;
	40919, 41082, 44080	TBT art. 2.1.
Standards for contaminants	Cal. Health & Safety Code	Science, SPS art.2.2;
	39655	Risk assmt., SPS art. 5.1-5.8.
Standards for motor fuels	Cal. Health & Safety Code	Unnecess. obstacle, TBT art. 2.2.
	13440, 41954, 43830	
Standards for sources of pollution	Cal. Health & Safety Code	Science, SPS art. 2.2;
	41706 et seq.	Risk assmt., SPS art. 5.1-5.8.
Restrictions on detergents that	Cal. Health & Safety Code	Science, SPS art. 2.2;
are found to harm health or environment	41712, 27606	Risk assmt., SPS art. 5.1-5.8.
Waste treatment standards	Cal. Health & Safety Code	Science, SPS art. 2.2;
	25179.4-25179.6	Risk assmt., SPS art. 5.1-5.8.
Noise - emission standards	Cal. Vehicle Code 38370	Science, SPS art. 2.2;
		Risk assmt., SPS art. 5.1-5.8.
Tires - importation requirements	Cal. Health & Safety Code	Science, SPS art. 2.2;
for used tires (mosquito inspection)	23010	Risk assmt., SPS art. 5.1-5.8;
		Unnecess. obstacle, TBT art. 2.2.
Drinking water - safety standards	Ch. 6.6	Science, SPS art. 2.2;
(i.e. Safe Drinking Water and		Risk assmt., SPS art. 5.1-5.8;
Toxic Enforcement Act of 1986)		Unnecess. obstacle, TBT art. 2.1;
		Equivalence, SPS art. 4.1.
2. Occupational Safety & Health		
Worker protection - standards for	Cal. Labor Code 6717	Science, SPS art. 2.2;
lead related construction work		Risk assmt., SPS art. 5.1-5.8;
		Unnecess. obstacle, TBT art. 2.1.
Occupational safety and health	Cal. Lab. Code Div. 5, Part 1;	Science, SPS art. 2.2;
standards - worker right to know	Cal. Lab. Code 6361	Risk assmt., SPS art. 5.1-5.8.

State law provisions	Cite	Potential conflict
		with GATT
3. Toxic Materials		
Lead acid batteries – fees for dealers	Cal. Health & Safety Code	Science, SPS art. 2.2;
	25215.3 et seq.	Risk assmt., SPS art. 5.1-5.8.
Asbestos protection – licensing of workers	Cal. Bus. & Prof. Code 7065	Science, SPS art. 2.2;
		Risk assmt., SPS art. 5.1-5.8.
Buffer zones - waste disposal facilities	Cal. Health & Safety Code	Science, SPS art. 2.2;
	25200	Risk assmt., SPS art. 5.1-5.8.
Community right to know	Cal. Health & Safety Code	Science, SPS art. 2.2;
	25531.1	Risk assmt., SPS art. 5.1-5.8.
Hazardous material - emergency	Cal. Health & Safety Code	Science, SPS art. 2.2;
planning and insurance requirement	Ch. 6.95	Risk assmt., SPS art. 5.1-5.8.
Table wares standards - release	Cal. Health & Safety Code	Science, SPS art. 2.2;
of lead and cadmium	25886	Risk assmt., SPS art. 5.1-5.8;
		Unnecess. obstacle, TBT art. 2.2.
Wine - lead content standards	Cal. Health & Safety Code	Science, SPS art. 2.2;
	26530.1	Risk assmt., SPS art. 5.1-5.8;
		Unnecess. obstacle, TBT art. 2.2.
Medical waste - containment,	Cal. Health & Safety	Science, SPS art. 2.2;
storage and treatment.	Division XX, Ch.6.1., art. 8, 9	Risk assmt., SPS art. 5.1-5.8.
D. Labor and Economic Development		
1. Business Development		
Small business assistance - infrastructure	Cal. Govt. Code Ch. 6.7	Natl. treatment, art. III;
	Cal. Govt. Code 4535.2, 14839	TBT art. 2.1.
Subsidy for tourism -	Ca. Govt. Code 6107	Natl. treatment, art. III;
Commerce Marketing Fund		TBT art. 2.1.
		Natl. treatment, art. III;
Customized job training	Cal. Unemp. Ins. Code 10209,	TBT art. 2.1.
	10527, 15020	
	Cal. Corp. Code 14202	
2. California Business Preference		
National business preference -	Cal. Govt. Code 4300.	Natl. treatment, art. III;
exemption for pre-1969 "Buy America"		TBT art. 2.1.
and "Buy California" programs		
Wage standards – prevailing wage for	Cal. Lab. Code 1771	Natl. treatment, art. III;
workers employed on public works		TBT art. 2.1.
		Unnecess. obstacle, TBT art. 2.2.
Preference to California	Cal. Govt. Code 6107	Natl. treatment, art. III;
businesses	Cal. Govt. Code 4533	TBT art. 2.1;
		Govt. procurement.

State law provisions	Cite	Potential conflict
		with GATT
Public procurement – preference for	Cal. Govt. Code 4533	Natl. treatment, art. III;
companies that use California-based workers		TBT art. 2.1;
		Govt. procurement.
Public construction contracts -	Cal. Pub. Con. Code 6107	Natl. treatment, art. III;
reciprocal preference requirement		TBT art. 2.1;
		Govt. procurement.
Public procurement - preference	Cal. Govt. Code 14838 (f)	Natl. treatment, art. III;
for California-based small		TBT art. 2.1;
businesses		Govt. procurement.
3. Other		
Wage standards - prevailing	Cal. Lab. Code 1771	Natl. treatment, art. III;
wage for workers employed on		TBT art. 2.1;
public works		Unnecess. obstacle, TBT art. 2.2.
E. Natural Resource Conservation		
1. Energy Conservation		
Energy conservation markets procurement	No provision found	Natl. treatment. art. III;
		TBT art. 2.1.
Motor vehicle fuel - limits on	Cal. Health & Safety Code	Science, SPS art. 2.2;
future use	25372 et seq.	Risk assmt., SPS art. 5.1-5.8;
		Unnecess. obstacle, TBT art. 2.2
Alternative fuels incentive grants	Cal. Health & Safety Code	Natl. treatment. art. III;
	41082, 41241	TBT art. 2.1.
	Cal. Pub. Util. Code 745	
	Cal. Pub. Res. Code 25648	
Oil and gas conservation	Cal. Pub. Res. Code	Unnecess. obstacle, TBT art. 2.2.
	Division III, Ch. 1	
2. Product Packaging		
Packaging, labeling, and advertising - content	Cal. Health & Safety Code	Unnecess. obstacle, TBT art. 2.2.
	Division 21, Ch. 4	
Recyclable bottles/packaging	Cal. Pub. Res. Code 42301	Unnecess. obstacle, TBT art. 2.2.
Beverage containers - classification and	Cal. Health & Safety Code	Risk assmt., SPS art. 5.1-5.8;
biodegradable requirement	24384.5	Science, SPS art. 2.2.

State law provisions	**Cite**	**Potential conflict**
		with GATT
3. Recycled Content		
Recycling markets – state and municipal	Cal. Pub. Cont. Code Ch. 4	Natl. treatment, art. III;TBT art. 2.1.
Recycled content	Cal. Pub. Res. Code 42211	Unnecess. obstacle, TBT art. 2.2.
Newsprint quality -	Cal. Pub. Res. Code 42775	Risk assmt., SPS art. 5.1-5.8;
recycled content		Equivalence, SPS art. 4.1.
Glass - Clean Glass Recycling Act	Cal. Pub. Res. Code 70000	Science, SPS art. 2.2;
(ceramic glass use prohibited)	et seq.	Risk assmt., SPS art. 5.1-5.8;
		Unnecess. obstacle, TBT art. 2.2.
Paving - use of recycled materials required	Cal. Pub. Res. Code 42700	Unnecess. obstacle, TBT art. 2.1;
		Equivalence, SPS art. 4.1.
Public procurement - recycled	Cal. Pub. Con. Code	Govt. procurement, art. III (Natl.
paper requirement	Division II, Part 2, Ch.2.,	Treatment); Unnecess. obstacle,
	art.1.	TBT art. 2.2.
Fiberglass - Fiberglass Recycled	Cal. Pub. Res. Code	Science, SPS art. 2.2;
Content Act	Division 12.9, art. 2-4	Risk assmt., SPS art. 5.1-5.8;
		Unnecess. obstacle, TBT art. 2.2.
4. Wildlife Conservation		
Importation of wild animals	Cal. Fish & G Code 2120	Science, SPS art. 2.2;
	et seq.	Risk assmt., SPS art. 5.1-5.8.
Importation, sale and release of wildlife	Cal. Fish & G Code 2120	Science, SPS art. 2.2;
	et seq.	Risk assmt., SPS art. 5.1-5.8.
Migratory bird protection hunting regulations	Cal. Fish & G Code 356,	Science, SPS art. 2.2;
and incorporation of federal laws	3130 et seq.	Risk assmt., SPS art. 5.1-5.8.
Endangered species -	Cal. Fish & G Division III, art.	Science, SPS art. 2.2;
classification, importation and	1.5 - 4	Risk assmt., SPS art. 5.1-5.8;
transportation		Unnecess. obstacle, TBT art. 2.2.
F. Taxation		
Corporate tax based on income -	Cal. Rev. & Tax Code 25128	Natl. treatment, art. III;
unitary taxation		TBT art. 2.1.

State law provisions	Cite	Potential Conflict
		with GATT
Uniform division of income for tax purposes	Cal. Rev. & Tax Code 25128	Natl. treatment, art. III;
		TBT art. 2.1.
Tax credit for purchase of low emission	Cal. Rev. & Tax Code 17052.11	Natl. treatment, art. III;
vehicles or conversion devices		TBT art 2.1. Tax subsidy,
		SCM art. 1.1.
Tax credit for industrial	Cal. Rev. & Tax Code 23649	Natl. treatment, art. III;
development (in-state property)		TBT art. 2.1. Tax subsidy,
		SCM art. 1.1.
Tax rebate for economic	Cal. Rev & Tax Code 5108	Natl. treatment, art. III;
revitalization (high tech. industry)		TBT art. 2.1. Tax subsidy,
		SCM art. 1.1.
Tax exemption on fuel used by	Cal. Rev & Tax Code 8655	Natl. treatment, art. III;
private entity under contract with		TBT art. 2.1.
public entity		Tax subsidy, SCM art. 1.1.
G. Transportation		
Vehicle equipment and	Cal. Vehicle Code	Unnecess. obstacle, TBT art. 2.2.
inspection - medium and heavy trucks & buses	Division XII. Ch. 3.5;	
	Division XXVI, Ch. 3	
General requirements for braking systems	Cal. Vehicle Code 26311	Unnecess. obstacle, TBT art. 2.2.
Hazardous materials transportation -	Cal. Health & Safety Code	Unnecess. obstacle, TBT art. 2.2.
prohibited without a manifest	25169.1	
Commercial drivers license requirements	Cal. Vehicle Code Division VI,	Unnecess. obstacle, TBT art. 2.2.
	Ch. 7.	
Insurance requirements-proof	Cal. Vehicle Code 6854	Unnecess. obstacle, TBT art. 2.2.
required for commercial vehicles		

Source: Stumberg, 1994, p. 27.

Appendix 4: Current U.S. State and Municipal Foreign Economic Sanctions

State/Municipality	Target Country	Status	
Alameda County, CA	**Burma**	**Selective purchasing and investment**	**Enacted December 1996.**
Alameda County, CA	*Nigeria*	*Selective purchasing and investment*	*Enacted October 1997.*
Amherst, MA	*Nigeria*	*Selective purchasing and investment*	*Enacted September 1997.*
Ann Arbor, MA	**Burma**	**Selective purchasing**	**Enacted April 1996.**
Berkeley, CA	**Burma**	**Selective purchasing**	**Enacted March 1995.**
Berkeley, CA	**Nigeria**	**Selective purchasing**	**Enacted July 1997.**
Berkeley, CA	Tibet	Selective purchasing	Enacted June 1997.
Boulder, CO	*Burma*	*Selective purchasing*	*Enacted December 1996.*
Brookline, MA	**Burma**	**Selective purchasing**	**Enacted November 1997.**
Cambridge, MA	**Nigeria**	**Selective purchasing**	**Enacted May 1997.**
Cambridge, MA	**Burma**	**Selective purchasing**	**Enacted June 1998.**
Cambridge, MA	**Indonesia**	**Selective purchasing**	**Enacted August 1998.**
Carrboro, NC	*Burma*	*Selective purchasing*	*Enacted October 1996.*
Chapel Hill, NC	*Burma*	*Selective purchasing*	*Enacted January 1997.*
Dade County, FL	*Cuba (1)*	*Selective purchasing and investment*	*Enacted July 1992; updated June 1993*
Los Angeles	*Burma*	*Selective purchasing*	*Enacted December 1998.*
Madison, WI	**Burma**	**Selective purchasing**	**Enacted August 1996.**
Massachusetts	*Burma*	*Selective purchasing*	*Enacted July 1996.*

State/Municipality	Target Country	Status	
New York, NY	**Burma**	**Selective purchasing**	**Enacted May 1997.**
Newton, MA	*Burma*	*Selective purchasing*	*Enacted November 1997.*
Oakland, CA	*Nigeria*	*Selective purchasing and investment*	*Enacted May 1997.*
Oakland, CA	*Burma*	*Selective purchasing*	*Enacted May 1996.*
Palo Alto, CA	*Burma*	*Selective purchasing*	*Enacted October 1997.*
Philadelphia, PA	N. Ireland	Selective purchasing	Enacted 1989; amended 1991, 1994, 1995.
Portland, OR	*Burma*	*Selective purchasing*	*Enacted July 1998.*
Quincy, MA	Burma	Selective purchasing	Enacted November 1997.
San Francisco, CA	*Burma*	*Selective purchasing*	*Enacted April 1995.*
Santa Cruz, CA	*Burma*	*Selective purchasing*	*Enacted July 1997.*
Somerville, MA	*Burma*	*Selective purchasing*	*Enacted February 1998.*
Takoma Park, MD	*Burma*	*Selective purchasing*	*Enacted October 1996.*
Vermont	Burma	Selective purchasing	Enacted May 1999.
West Hollywood, CA	*Burma*		*Enacted October 1997*
West Hollywood, CA	*Arab League boycott of Israel*	*Selective purchasing*	*Enacted October 1997.*

Notes:
Bold denotes a law which was confirmed by the municipality as currently not being enforced.
Italic denotes a law which was suspended or repealed.
1. Broadened to include companies violating the Cuban Liberty and Democracy Act.

Source: Organization for International Investment website.

Appendix 5: U.S. Gross State Products vs. National Gross Products

(millions of U.S. dollars)

	1995	1996	1997	1998
Australia	376,650	417,597	419,986	372,723
Belgium	275,744	268,208	243,540	250,391
Brazil	704,168	774,869	803,585	774,967
California	924,582	971,777	1,043,669	1,118,945
Canada	579,232	601,589	624,144	598,249
China	700,219	816,490	898,244	946,312
Florida	344,381	365,837	391,073	418,851
France	1,553,130	1,554,360	1,460,120	1,446,950
Georgia	202,750	218,381	233,773	253,769
Germany	2,458,250	2,383,080	2,114,460	2,150,520
Greece	117,564	124,361	120,933	121,533
Illinois	359,843	376,489	402,282	425,679
India	353,222	383,640	407,890	419,070
Michigan	253,940	264,848	280,178	294,505
New Jersey	271,297	285,528	303,580	319,201
New York	597,823	634,150	669,446	706,886
Ohio	295,207	305,559	325,239	341,070
Pennsylvania	318,066	328,704	347,169	364,039
Spain	584,188	608,814	558,568	582,137
Texas	515,433	555,609	606,901	645,596
United Kingdom	1,126,740	1,179,580	1,318,520	1,410,430
United States	7,338,400	7,751,100	8,329,000	8,699,200

Source: Gross State Products are from U.S. Bureau of Economic Analysis, Department of Commerce. Gross National Products are from The World Bank website.

Appendix 6: Research approach (unabridged)

Research to determine the actors, their agendas, their assets, and the various channels of negotiation in the debate over California's unitary tax method consisted of surveying a wide variety of participants in the debate to allow a general assessment of the relative importance of different actors and policy channels in the "judgments of well-placed observers".[1]

In addition, a search was conducted of all relevant news articles from major U.S. and European newspapers to gain a fundamental understanding of the different arguments put forth and how the issue developed. The news articles examined started in 1986, the year California first passed legislation on the issue, and finished in 1996. All of the documents surveyed were then analyzed to identify relevant companies, state and federal government offices, industry associations, and law and consulting firms which were active in the debate; persons regularly mentioned within these organisations were catalogued.

Interviews were obtained by writing letters to the persons identified by the news search, with follow-up phone calls. Each participant was asked to identify other key players in the debate. This approach helped to ensure that the case study did not miss important players who had not been quoted in the press, or who had changed jobs since the time of the legislation. Many of those interviewed were employed by lobby organisations or the government. Few corporate people were mentioned directly by name in the press, and the lobbying groups which had represented MNEs in the unitary debate were reluctant to divulge client names. Also, due to the detailed and technical nature of the issue, many corporate representatives were not involved in the debate on a day-to-day basis.

However, it proved surprisingly easy to identify and meet with key legislative officials and lobbyists who had worked on the unitary tax issue at the state level from the

early 1980s. A small and tightly-woven group of California state tax policy experts was quickly discovered. Due to their relatively specialised knowledge base, if key players at the state level had changed employment since the time of the unitary legislation, it was most often to take another position within the same group of experts.

Interviews were conducted in Washington DC and New York City (June 1997); in Sacramento and Los Angeles, California (January/February 1998), and in London (May 1998). In total, 52 interviews were conducted.

After the initial sessions, follow-up questions were conducted by phone, fax, and email. The original sessions were audiotaped, then transcribed, along with any clarifications from the follow-up correspondence. All of the research material gathered was used to examine the multilevel layers of bargaining which took place over California's unitary tax, and to identify levers of influence on all sides. Due to the sensitive nature of both the lobbying process and taxation issues, interviewees are not quoted directly.

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[1] Robert Dahl, 1963, p. 52.

Appendix 7: Foreign Direct Investment in the United States, Capital Inflows

(millions of U.S. dollars; outflows -)

	1980	1981	1982	1983	1984	1985	1986	1987
All countries	16,918	24,401	13,842	11,441	25,359	17,856	34,091	41,977
Canada	3,278	1,998	-1,439	111	3,294	572	2,547	959
Europe	9,805	14,732	10,610	9,058	14,686	13,127	21,730	34,974
European Communities	8,661	14,005	9,588	8,097	13,292	9,601	19,095	31,352
Belgium	263	323	27	290	302	-267	597	88
France	675	1,959	-199	79	774	-252	1,017	2,551
Germany	219	1,638	427	796	1,291	1,962	1,982	2,403
Italy	99	374	337	152	197	-58	114	-364
Luxembourg	-2	35	52	-31	129	-180	-45	128
Netherlands	4,432	5,190	3,510	2,613	3,520	2,684	4,374	7,871
United Kingdom	2,938	4,406	5,383	4,055	6,882	5,303	10,827	18,562
Denmark, Greece, and Ireland	37	80	52	143	196	410	228	369
Other Europe	1,144	727	1,021	961	1,395	3,525	2,635	3,622
Sweden	265	7	43	337	216	190	1,395	744
Switzerland	719	483	914	615	1,035	3,028	1,414	2,582
Other	161	236	64	9	144	308	-174	296
Japan	948	2,960	1,987	1,440	4,374	3,081	7,268	6,181
Australia, New Zealand, and South Africa	77	272	142	170	1,148	558	2,719	996
Latin America	2,301	1,700	1,621	455	615	684	-332	-1,453
South and Central America	327	138	437	60	90	478	826	-29
Panama	210	75	314	-12	-167	166	56	-34
Other	117	63	123	72	258	313	769	5
Other Western Hempishere	1,974	1,562	1,184	395	525	205	-1,157	-1,423
Bermuda	249	-48	304	-119	-84	546	19	49
Netherlands Antilles	1,406	1,417	995	330	848	-495	-750	-482
U.K. Islands, Caribbean	188	254	-43	225	-257	132	-554	-880
Other	132	-62	-72	-41	18	22	127	-102
Middle East	234	2,660	806	28	791	-357	-68	193
Israel	32	-12	94	22	76	-2	49	-57
Other	202	2,672	711	6	715	-354	-117	250
Other Africa, Asia, and Pacific	275	80	116	179	449	192	228	128
Memorandum--OPEC	240	2,685	719	10	754	-332	294	212

Source: Survey of Current Business, U.S. Department of Commerce.

Appendix 8: GATT "Beer II" decision

In a suit brought by the Canadian government, a GATT panel concluded in June of 1992 that U.S. federal and state laws which discriminated in favour of U.S. state beer companies by granting tax breaks to microbreweries were illegal, and ordered the U.S. to end the discrimination.[1] Although the U.S. and Canadian governments reached a bilateral trade accord which removed the dispute from the GATT arbitration process, the matter was quietly dropped by both the U.S. and Canadian government; the U.S. government has not followed up on promises to ask Congress to change the federal laws in dispute or to pressure the states to change their laws.[2]

Nevertheless, states' rights advocates were alarmed by the GATT panel's ruling, viewing it as an extreme application of the GATT rule that jurisdictions should employ least-restrictive trade measures. They feared it set a precedent for GATT to hold any U.S. state to the standard of "the one state with the laws most favorable to imported products".[3] The Beer II ruling is therefore seen by many state advocates as directly conflicting with the federalist principle of allowing diverse state regulations. Further, the prohibition against "unnecessary barriers to trade" under GATT Article XX "means that the mere fact of differences in the laws of the states may be sufficient to find their laws in violation of GATT non-discrimination rules".[4] The European Commission has described U.S. state regulation as a "multiplicity of standards" which creates "impediments and even barriers to trade",[5] resulting in the "fragment of the U.S. market".[6] Beer II helped drive the states to demand exemptions for state regulations when the U.S. joined the World Trade Organisation and the North American Free Trade Agreement, requiring the U.S. federal government to consult with the states when state regulations were brought into question by multilateral organisations.

[1] Morton, 1997, p. 8.
[2] Ibid., p. 16.
[3] Weiler, 1996, p. 8.
[4] Ibid., p. 9.
[5] Stumberg, 1994, p. 1.
[6] Ibid., p. 4.

Appendix 9: Taxation of U.S. MNEs' Foreign-Sourced Dividends

Several large U.S. companies with extensive international interests complained that if they were taxed on foreign dividends when they elected a water's edge assessment, California would not give them credit for the foreign taxes they had already paid on the overseas factors of production used to generate those dividends or for the generally high foreign government withholding taxes imposed on the dividends themselves. However, if either a U.S. or foreign-domiciled company filed on a worldwide combined basis, any dividends entering the U.S. from overseas businesses were considered to be interfirm payments, and were weighted against the foreign property, payroll, and sales used to generate the dividends. U.S. MNEs argued that including their foreign dividends in a water's edge assessment made the water's edge system too expensive for them to use in many cases.

Therefore, U.S. MNEs with extensive international investments stated they would be forced to continue to file on a worldwide combined (WWC) basis and would not receive the benefit of lowered taxes possible from filing under a water's edge assessment. This would place U.S.-incorporated companies doing most of their business overseas at a disadvantage to their overseas competitors, since it offered an exemption from the WWC method as a viable possibility to foreign MNEs but not domestic MNEs. These U.S. MNEs further pointed out that both the Worldwide Unitary Working Group and proposed federal legislation had insisted on equity for foreign and domestic companies. They stated that taxing foreign dividends effectively penalised U.S. MNEs which were successful overseas, and subsidised poorly-performing firms by allowing them to deduct foreign losses from their U.S. profits under the WWC method. U.S. MNEs which were particularly active in lobbying against SB85 included Colgate-Palmolive, Johnson & Johnson, Singer, Allegheny International, Reynolds Metals, and Goodyear.

However, legislators argued that an exclusion for foreign dividends would encourage U.S. companies to invest overseas instead of domestically, and that state taxes play a relatively minor role in MNE investment location decisions in any case. They stated U.S. MNEs would not necessarily be at a disadvantage to foreign MNEs, since foreign MNEs often faced taxes in their home countries on dividends they received from their U.S. subsidiaries. They further argued that dividend payments are often used as surrogates for interest, royalty payments, and reductions in the cost of goods sold, particularly from overseas. Thus, to measure income accurately and prevent accounting manipulations to avoid taxation, foreign dividends must be taxed as income. In any case, the federal definition of water's edge income included foreign dividends, and any double taxation of foreign subsidiaries would be partially alleviated by the federal foreign tax credit, which allowed an 85% deduction; therefore, exempting foreign dividends from state taxation would duplicate federal efforts. At the time, roughly two-thirds of U.S. states included at least some foreign-source dividends in the tax base of U.S. parent corporations, making this type of taxation the state norm.

Domestic MNEs were seen as unwilling to compromise in their continued insistence on a 100% exclusion of their foreign-sourced dividends from the water's edge method, and some of the original allies of U.S. MNEs on this issue, such as Assemblyman Dennis Brown (R-Long Beach), Tom Hannigan (D-Fairfield), and Senate Republican leader Jim Nielsen, grew frustrated with their intransigence. The California Business Council therefore concentrated on killing the unitary reform bill because they knew it would be extremely difficult to get a 100% dividend exclusion when Governor Deukmejian and Senate President Pro Tem David Roberti (D-LA) opposed it as both expensive and an encouragement to U.S. firms to export jobs overseas.[1]

[1] Interview #25.

Appendix 10: 80/20 Companies

80/20 companies are those with extensive overseas operations which only conduct the minimum 20% of their business in the U.S. necessary to maintain their U.S. incorporation: this affords them U.S. legal protection, particularly for royalty payments on intellectual property rights. Many felt California should not include 80/20 companies in its definition of water's edge income because, under U.S. federal law, any U.S. company with more than 80% of its business overseas had its income treated as if it were all foreign-sourced, and was therefore subject to foreign tax credits. However, U.S. 80/20 corporations argued their substantial overseas subsidiaries should be excluded from California's water's edge definition so that they would be on an equal playing field with their main competitors, foreign-incorporated firms, whose subsidiaries were not being included in California's water's edge definition.

The California Franchise Tax Board, however, argued that excluding the subsidiaries of 80/20 companies from the water's edge definition would make it problematic to audit their activities, as the federal government did not conduct full corporate audits of 80/20 subsidiaries. The U.S. Internal Revenue Service was only moderately concerned with auditing the inner-group transactions of 80/20 companies, because any shifting of tax burdens within such a group would have no effect on the overall tax liability of the group. The states argued that if they did not police these inner-company transactions, no one would, and the 20% of activities these companies conducted within the U.S. would not be properly audited. Corporations argued the IRS would audit these transactions for the purpose of limiting foreign tax credits. However, this type of audit does not typically result in any adjustment of income between the entities of the consolidated group. 80/20 companies argued that excluding them from using the water's edge method was a heavy price to pay for what was essentially an administrative problem.

This conflict arose because California used a company's 'place of incorporation' as the criterion for determining which firms were to be combined for apportionment, irrespective of whether they operated in the U.S., instead of the `place of business' criterion, which is based on where a corporation's business operations are primarily conducted geographically.

Appendix 11: Mandatory vs. Optional Worldwide Combination

Although most U.S. companies wanted to use the water's edge method, during the debate leading up to California's 1986 unitary reform legislation, several large U.S. multinational enterprises (MNEs) were in favour of legislation offering companies the choice of filing under the WWC or water's edge methods, since they paid lower taxes in California by using the worldwide combined (WWC) method. Standard Oil, IBM, and Procter & Gamble were all in favour of an election, and the California Chamber of Commerce supported the election in an attempt to find common ground for the business community. Although few in number, these companies were economically powerful, and they had the support of key legislators.[1] The election option was therefore included in most of the legislative efforts to reform the WWC method, even though it raised the cost of the bill considerably.[2]

The California Business Council (CBC) and the Committee on State Taxation (COST), however, were both in favour of an outright prohibition on the WWC method, not an election. These groups thought that pressing for an election was too risky, since it would raise the price of the reform bill. In addition, they felt that asking the legislature to allow companies to use the WWC method would make it that much more difficult for them to argue that worldwide combination was an unfair method. The California Franchise Tax Board (FTB) remained adamantly opposed to giving companies a choice, since they felt this violated correct tax principles and would promote tax evasion. The FTB attached very large revenue loss estimates to an election: in June 25, 1986, the FTB estimated that allowing taxpayers to choose between the two assessment methods would raise the cost of SB85 by $280 million.

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[1] Interview #42.
[2] Ibid.

Appendix 12: U.S. Internal Revenue Service Revisions to the Arm's Length Standard

In 1988, the Treasury and IRS issued a draft "White Paper" outlining transfer pricing regulations that let multinational enterprises choose one of the following methods (ranked in order of preference) to allocate income from intangible goods: 1) exact comparables; 2) inexact comparables; 3) the Basic Arm's Length Rate of Return (BALRM, or "ballroom") method; 4) BALRM plus profit split. BALRM divides a firm's overall profit between the company's tangible and intangible goods by estimating the 'correct' market rate of return for the firm's factors of production. Any remaining income would then be allocated to the owner of the intangible good. If both company units involved in a transaction owned intangible goods, the profit split method would then be used to split the income from intangible goods according to the "relative value of the intangibles of each party".[1]

[1] Muchlinski, 1995, p. 292.

Appendix 13: Threatened U.S. Subfederal Sanctions Over Holocaust Survivor Claims on Swiss Banks

In 1998, a coalition of U.S. local and state finance officers threatened sanctions against Swiss banks over the issue of asset claims against these banks by Holocaust survivors and their heirs. New York City's comptroller organised a network of nearly 900 city and state treasurers and pension-fund controllers, who announced that, pending a satisfactory settlement of claims by Jewish groups, their members would implement a phased-in schedule of economic sanctions, first against Swiss banks, and eventually against other Swiss enterprises. Such sanctions included plans to "stop placing overnight deposits in Swiss banks in September 1998; prohibit new pension fund money-management contracts with, and trading through, Swiss banks in mid-November; cancel existing fund-management contracts with Swiss banks and seek legislation to exclude Swiss companies from state procurement bids in January 1999; and sell all Swiss company stocks held in public pension funds by mid-1999".[1]

Further pressure came when the New York state banking department threatened to delay an operating license for the proposed merger of the Union Bank of Switzerland and the Swiss Bank Corporation. However, "New York's regulators relented and allowed the merger to proceed after receiving assurances through a U.S. government official that the banks were willing to increase their settlement offer".[2] Mediation by the U.S. Deputy Secretary of State and a federal district court judge led to an out-of-court agreement for a substantial settlement with Holocaust survivors. In early 1999, similar pressures were directed against Germany to compensate workers enslaved by the Nazi regime during World War II. The push to create a German reparations fund reportedly came after Deutsche Bank's proposed merger with Banker's Trust in the U.S. "appeared threatened with state and local regulatory objections similar to those posed in the Swiss bank case".[3]

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[1] Kline, 1999, p. 123.
[2] Ibid., p. 124.
[3] Ibid., p. 131.

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Chart 1: California General Fund Revenues, 1983-1994

	1983	% of total	1984	% of total	1985	% of total	1986	% of total
Personal Income Tax	7,912.7	37.3%	10,016.2	40.5%	12,021.5	40.8%	12,021.5	41.4%
Bank and Corporation Tax	2,876.8	13.5%	3,414.1	13.8%	4,219.9	13.9%	4,219.9	14.5%
Subtotal collected by FTB	10,789.5	50.8%	13,430.3	54.3%	16,241.4	54.7%	16,241.4	56.0%
Retail Sales and Use Tax	7,959.5	37.5%	9,165.2	37.0%	10,057.5	36.3%	10,057.5	34.7%
Estate, Gift and Inheritance Tax	337.8	1.6%	283.2	1.1%	273.2	0.9%	273.2	0.9%
Insurance Company Tax	715.3	3.4%	480.0	1.9%	828.4	2.9%	828.4	2.9%
Cigarette Tax	177.3	0.8%	184.4	0.7%	183.3	0.7%	183.3	0.6%
Alcoholic Beverage Excise Tax	136.9	0.6%	137.4	0.6%	133.4	0.5%	133.4	0.5%
Horse Racing Fees	112.3	0.5%	113.9	0.5%	121.4	0.4%	121.4	0.4%
Other Revenues Plus Interest on Investments	1,012.1	4.8%	952.4	3.9%	1,181.2	3.9%	1,181.2	4.1%
Subtotal	10,451.2	49.2%	11,316.5	45.7%	12,778.5	45.3%	12,778.5	44.1%
GRAND TOTAL	**21,240.7**	**100.0%**	**24,746.8**	**100.0%**	**29,020.0**	**100.0%**	**29,020.0**	**100.0%**

Chart 1 (continued):

	1987	% of total	1988	% of total	1989	% of total	1990	% of total
Personal Income Tax	14,596.9	43.5%	14,379.9	41.8%	16,326.9	43.3%	17,219.3	43.9%
Bank and Corporation Tax	4,999.5	14.9%	5,073.9	14.7%	5,147.3	13.7%	4,768.9	12.2%
Subtotal collected by FTB	19,596.4	58.4%	19,453.8	56.5%	21,474.2	57.0%	21,988.2	56.1%
Retail Sales and Use Tax	11,114.7	33.1%	11,907.7	34.6%	12,984.6	34.5%	13,851.7	35.4%
Estate, Gift and Inheritance Tax	253.5	0.8%	406.0	1.2%	350.9	0.9%	427.1	1.1%
Insurance Company Tax	1,087.8	3.2%	1,208.2	3.5%	1,268.8	3.4%	1,219.3	3.1%
Cigarette Tax	176.6	0.5%	174.1	0.5%	153.1	0.4%	149.9	0.4%
Alcoholic Beverage Excise Tax	130.2	0.4%	131.5	0.4%	127.6	0.3%	131.6	0.3%
Horse Racing Fees	105.1	0.3%	109.8	0.3%	111.7	0.3%	112.4	0.3%
Other Revenues Plus Interest on Investments	1,100.5	3.3%	1,018.6	3.0%	1,220.0	3.2%	1,301.9	3.3%
Subtotal	13,968.4	41.6%	14,955.9	43.5%	16,216.7	43.0%	17,193.8	43.9%
GRAND TOTAL	**33,564.8**	**100.0%**	**34,409.7**	**100.0%**	**37,690.9**	**100.0%**	**39,182.0**	**100.0%**

Chart 1 (continued):

	1991	% of total	1992	% of total	1993	% of total	1994	% of total
Personal Income Tax	17,024.7	43.4%	17,427.7	43.4%	17,497.6	43.4%	17,468.6	43.9%
Bank and Corporation Tax	4,215.9	10.7%	4,482.6	11.1%	4,967.1	12.3%	4,962.7	12.5%
Subtotal collected by FTB	21,240.6	54.2%	21,910.3	54.5%	22,464.7	55.7%	22,431.3	56.3%
Retail Sales and Use Tax	14,196.7	36.2%	15,143.7	37.7%	14,509.8	35.9%	14,068.6	35.3%
Estate, Gift and Inheritance Tax	497.0	1.3%	469.4	1.2%	244.0	1.2%	520.4	1.3%
Insurance Company Tax	1,312.3	3.3%	1,144.1	2.8%	118.2	2.9%	1,135.2	2.9%
Cigarette Tax	156.7	0.4%	159.7	0.4%	188.8	0.5%	173.6	0.4%
Alcoholic Beverage Excise Tax	212.8	0.5%	297.5	0.7%	283.8	0.7%	280.7	0.7%
Horse Racing Fees	96.6	0.2%	84.9	0.2%	76.4	0.2%	76.0	0.2%
Other Revenues Plus Interest on Investments	1,508.9	3.8%	972.9	2.4%	1,414.1	2.8%	1,140.2	2.9%
Subtotal	17,981.0	45.8%	18,272.2	45.5%	17,862.4	44.3%	17,394.6	43.7
GRAND TOTAL	**39,221.5**	**100.0%**	**40,182.5**	**100.0%**	**40,330.1**	**100.0%**	**39,825.9**	**100.0%**

Source: Franchise Tax Board, annual reports, 1983-1994.

Chart 2: California Bank and Corporation Tax Apportionment Formula

	1982	1984	1986	1988	1990	1992
	Amount (000)					
Total Property Values						
Within and without the state	3,084,553,192	2,991,501,533	7,813,058,607	7,148,229,659	9,525,832,946	8,893,399,307
Within the state	506,472,399	513,741,050	748,576,585	909,204,245	1,039,593,686	1,191,456,763
Statewide average	16.4%	17.2%	9.6%	12.7%	10.9%	13.4%
Total Wages and Salaries						
Within and without the state	613,486,790	662,732,825	674,182,136	740,964,248	1,045,106,351	1,190,062,717
Within the state	79,265,899	83,040,165	95,239,091	104,742,462	123,244,122	151,768,187
Statewide average	12.9%	12.5%	14.1%	14.1%	11.8%	12.8%
Total Sales						
Within and without the state	2,787,581,607	3,411,509,773	3,867,944,177	7,968,907,447	18,407,411,184	22,423,227,741
Within the state	333,687,658	408,097,089	509,214,639	687,077,086	1,031,758,144	1,295,410,939
Statewide average	12.0%	12.0%	13.2%	8.6%	5.6%	5.8%

Source: Franchise Tax Board, annual reports, 1982-1992.

Chart 3: California Gross State Product, selected years

(millions of current U.S. dollars)

	1980	1985	1990	1992	1994	1996	1998
Total Gross State Product	**$327,907**	**$528,950**	**$798,237**	**$830,950**	**$878,124**	**$971,777**	**$1,118,945**
Private industries	283,675	461,749	702,293	725,995	768,693	857,510	994,268
Agriculture, forestry, fish	9,442	11,014	16,354	16,511	18,341	19,567	20,900
Farms	7,243	7,657	10,344	10,037	11,246	11,787	11,645
Agricultural services	2,199	3,357	6,010	6,474	7,095	7,781	9,255
Mining	6,676	8,742	6,384	4,320	3,903	5,168	4,337
Metal mining	103	190	287	282	251	216	126
Coal mining	a/	a/	1	1	1	1	1
Oil & gas	6,134	8,067	5,396	3,383	2,863	4,058	3,106
Nonmetallic minerals	440	484	700	654	788	894	1,104
Construction	16,263	24,707	35,820	28,392	29,767	32,927	41,390
Manufacturing	58,847	85,922	118,016	116,068	119,740	134,669	154,608
Durable goods	38,477	58,633	77,483	71,666	74,344	86,785	103,277
Lumber & wood	2,122	2,192	3,266	2,680	2,953	2,727	3,105
Furniture and fixtures	1,073	1,529	1,697	1,693	1,634	2,010	2,762
Stone, clay, glass	1,747	2,125	2,699	2,352	2,551	2,561	3,382
Primary metals	2,070	1,581	1,951	1,493	1,751	2,161	2,307
Fabricated metals	4,355	5,765	6,209	5,648	6,297	7,222	8,300
Industrial machinery	6,909	8,941	16,110	16,303	15,656	19,527	24,980
Electronic equipment	9,882	18,917	17,923	17,037	19,364	25,248	29,506
Motor vehicles	1,034	1,542	1,214	1,328	3,109	2,573	2,926
Other transport. equip.	6,097	10,967	13,510	10,030	8,663	7,672	8,293
Instruments and related	2,126	3,685	10,762	11,211	9,853	12,169	14,093
Misc. manufacturing	1,062	1,386	2,142	1,890	2,515	2,915	3,623
Nondurable goods	20,371	27,290	40,533	44,401	45,395	47,884	51,331
Food & kindred products	6,331	8,179	12,447	13,437	12,604	13,275	13,763
Tobacco products	6	1	2	2	2	2	7
Textile mill products	318	423	606	629	712	736	1,003
Apparel & textile	1,659	2,364	3,564	4,043	4,316	4,599	4,592
Paper products	1,295	1,880	2,341	2,566	2,484	2,666	2,667
Printing & publishing	3,339	5,251	8,235	8,923	8,806	9,592	10,486
Chemicals	2,333	3,426	5,662	6,844	8,505	7,942	8,567
Petroleum products	3,476	3,681	4,690	5,079	4,661	5,446	6,194
Rubber & plastics	1,402	1,922	2,775	2,679	3,110	3,436	3,817
Leather products	212	163	211	200	196	189	235

Chart 3 (continued):

(millions of current U.S. dollars)

	1980	1985	1990	1992	1994	1996	1998
Transportation & utilities	24,659	40,629	56,715	57,898	65,132	70,419	81,756
Transportation	10,455	15,096	20,398	21,775	24,589	26,530	30,938
Railroad transportation	1,109	1,276	1,149	1,011	1,029	948	1,064
Local & interurban	511	763	992	1,240	1,296	1,464	1,828
Trucking & warehousing	3,964	5,857	7,161	7,390	8,551	9,123	10,741
Water transportation	723	1,182	1,591	1,562	1,701	1,945	2,187
Transportation by air	3,009	3,501	6,175	6,929	8,124	8,865	10,457
Pipelines, excl. nat. gas	67	153	188	204	230	267	283
Transportation services	1,073	2,364	3,142	3,439	3,657	3,918	4,379
Communications	8,403	14,326	18,326	19,574	22,650	25,473	31,214
Electric, gas & sanitary	5,800	11,206	17,991	16,549	17,893	18,416	19,603
Wholesale trade	23,699	37,366	52,158	56,102	61,644	67,927	77,932
Retail trade	33,005	53,062	72,153	76,425	80,984	89,058	102,726
F.I.R.E.	56,563	103,222	179,310	187,715	194,523	213,898	249,999
Depository institutions	6,867	11,772	24,819	23,924	21,901	23,496	28,825
Nondepository institution	1,022	3,179	3,620	4,159	4,137	4,875	10,601
Security brokers	1,189	2,755	4,038	5,069	6,832	9,525	11,811
Insurance carriers	3,957	3,731	7,662	9,780	11,522	12,294	14,458
Insurance agents	1,692	2,918	5,354	5,373	5,975	6,186	6,826
Real estate	41,427	76,711	133,141	138,618	143,245	156,719	174,832
Holding and investment	409	2,155	678	792	912	803	2,645
Services	54,522	97,085	165,382	182,564	194,658	223,877	260,620
Hotels & lodging	2,271	3,673	5,920	6,166	6,296	7,011	8,227
Personal services	2,213	3,557	5,404	5,836	6,343	6,601	7,284
Business services	11,802	24,149	34,682	37,098	43,172	57,018	73,256
Auto repair & parking	2,978	5,524	8,078	8,308	8,939	10,068	11,203
Misc. repair services	1,529	2,330	3,006	3,125	3,258	3,549	3,929
Motion pictures	3,249	5,836	9,517	9,322	10,248	13,072	14,757
Amusement and recreation	2,337	4,166	7,455	9,369	8,531	9,944	11,632
Health services	14,189	23,847	39,201	46,203	47,337	49,537	53,209
Legal services	3,161	6,621	13,210	14,765	13,970	14,236	16,553
Educational services	1,754	2,730	4,026	4,917	5,593	6,192	7,103
Social services	1,029	1,745	3,363	4,213	4,826	5,375	6,221
Membership organisations	1,973	2,718	4,249	4,582	4,948	5,107	5,510
Other services	5,227	8,939	25,430	26,649	29,001	33,800	38,952
Private households	811	1,249	1,839	2,012	2,196	2,366	2,784
Government	44,232	67,201	95,944	104,955	109,431	114,267	124,677
Federal civilian	8,345	12,384	16,201	18,382	19,096	19,058	19,954
Federal military	6,289	11,160	12,842	13,496	11,803	10,894	10,418
State and local	29,598	43,657	66,901	73,077	78,532	84,315	94,305
Electronic equip. + Instr.	12,009	22,603	28,686	28,248	29,217	37,418	43,599
Depository + Nondepository	7,888	14,951	28,438	28,083	26,038	28,371	39,426
Business serv. + Other serv.	17,028	33,088	60,112	63,747	72,173	90,818	112,208

a/ Less than $500,000.

Source: Bureau of Economic Analysis, U.S. Department of Commerce.

Chart 4: U.S. State Export Totals to the World

(thousands of U.S. dollars)

	1993	1994	1995	1996	1997	1998	1999	% change 1993-99
Alabama	2,504,344	3,115,364	3,587,068	3,702,427	4,537,234	4,560,189	4,898,862	95.6%
Alaska	817,873	887,672	891,543	850,416	969,016	758,508	949,966	16.2%
Arizona	5,785,148	6,970,648	8,402,790	9,937,766	13,556,747	10,752,998	10,123,011	75.0%
Arkansas	1,109,771	1,470,852	1,794,446	1,997,220	2,211,589	1,934,109	1,828,873	64.8%
California	**68,066,344**	**78,190,359**	**92,038,424**	**98,633,998**	**103,802,450**	**98,809,033**	**102,863,848**	**51.1%**
Colorado	6,214,809	7,802,107	9,688,769	10,064,946	11,329,185	10,733,342	11,171,162	79.8%
Connecticut	10,200,971	10,272,016	12,942,121	13,052,470	12,897,120	12,139,749	11,335,139	11.1%
Delaware	3,454,507	3,758,073	4,396,791	4,584,498	5,103,884	4,968,559	4,856,835	40.6%
D.C.	4,702,087	5,150,744	5,323,519	5,084,786	4,880,984	4,392,398	4,344,494	-7.6%
Florida	14,695,824	16,559,218	18,564,439	19,618,195	22,888,599	23,172,624	22,544,211	53.4%
Georgia	6,050,133	7,108,082	8,626,786	8,617,989	9,810,037	11,212,056	11,060,577	82.8%
Hawaii	216,771	237,398	255,686	295,176	303,166	211,372	243,506	12.3%
Idaho	1,235,896	1,530,506	1,892,550	1,610,103	1,716,069	1,459,982	2,116,580	71.3%
Illinois	20,347,213	24,534,201	30,478,211	32,224,851	34,225,044	33,838,066	30,856,534	51.6%
Indiana	8,445,190	9,533,979	11,051,969	12,119,025	13,097,315	13,949,086	14,583,916	72.7%
Iowa	1,955,741	2,331,362	2,577,824	2,695,060	3,116,724	3,411,725	2,985,168	52.6%
Kansas	3,109,413	3,498,265	4,461,452	4,971,283	5,133,178	4,402,843	4,856,336	56.2%
Kentucky	3,325,866	4,188,243	5,030,113	5,824,244	6,904,058	7,439,971	8,016,157	141.0%
Louisiana	3,220,327	3,576,895	4,580,707	4,730,822	4,373,491	4,391,867	3,947,304	22.6%
Maine	1,065,258	1,138,928	1,318,192	1,248,775	1,590,154	1,664,342	1,785,203	67.6%
Maryland	2,713,706	2,848,462	3,438,959	3,509,925	3,860,975	4,013,739	4,068,263	49.9%
Mass.	11,593,997	12,585,960	14,396,358	15,368,409	17,368,057	16,467,254	1,710,584	47.5%
Michigan	25,322,490	36,812,120	37,102,347	38,128,161	37,920,065	39,268,759	41,489,947	63.8%
Minnesota	9,974,369	10,011,066	12,404,328	13,884,051	13,793,273	13,499,436	14,400,804	44.4%
Mississippi	803,332	1,099,868	1,368,686	1,221,668	1,421,336	1,414,043	1,454,289	81.0%
Missouri	4,733,284	5,234,843	5,689,949	6,590,489	7,043,043	6,832,445	7,431,059	57.0%
Montana	243,265	259,954	279,190	340,869	429,822	390,025	403,999	66.1%
Nebraska	1,740,700	1,957,906	2,255,255	2,452,813	2,493,682	2,471,576	1,991,417	14.4%
Nevada	503,892	458,481	711,116	691,564	807,116	764,851	1,083,386	115.0%
New Hamp.	1,134,867	1,247,913	1,478,627	1,744,875	1,930,984	1,986,545	2,159,090	90.3%
New Jersey	14,540,560	16,760,765	18,368,587	18,458,394	20,815,367	20,032,935	21,007,591	44.5%
New Mexico	400,036	488,455	426,578	917,395	1,779,860	1,896,156	2,964,882	641.2%
New York	40,702,259	37,259,709	44,080,108	44,964,741	48,885,277	45,564,469	43,296,774	6.4%
N. Carolina	7,976,373	8,968,847	10,567,424	11,586,603	13,102,101	12,919,909	13,571,377	70.1%
N. Dakota	343,707	388,870	488,594	576,232	623,085	657,417	634,608	84.6%
Ohio	17,651,364	19,478,217	20,926,490	22,555,189	25,106,457	24,814,804	26,561,694	50.5%

Chart 4 (continued):

(thousands of U.S. dollars)

	1993	1994	1995	1996	1997	1998	1999	% change 1993-99
Oklahoma	2,334,587	2,171,959	2,467,324	2,537,565	2,721,629	2,623,241	2,405,277	3.0%
Oregon	6,204,733	6,987,407	9,902,084	8,481,327	8,358,568	8,143,544	11,164,311	79.9%
Penn.	13,189,649	14,698,634	17,680,205	17,445,572	19,298,414	19,138,811	19,527,654	48.1%
Rhode Island	938,387	1,011,548	956,796	954,826	1,126,500	1,113,086	1,104,714	17.7%
S. Carolina	3,219,519	3,510,116	4,497,870	4,924,922	5,673,836	5,856,943	6,476,471	101.2%
S. Dakota	213,811	263,888	348,556	397,332	435,264	373,541	1,143,374	434.8%
Tennessee	6,151,139	7,506,236	9,460,530	9,328,342	9,916,912	9,872,507	9,342,655	51.9%
Texas	35,622,483	40,488,977	45,192,646	48,252,054	56,292,938	59,029,288	61,705,632	73.2%
Utah	2,045,015	2,233,076	2,313,412	2,768,491	3,293,330	3,099,397	2,789,300	-10.0%
Vermont	2,276,004	2,304,297	2,683,579	2,610,829	2,592,089	2,757,708	2,826,650	24.2%
Virginia	8,118,380	9,947,272	10,425,230	10,925,992	11,512,427	11,459,928	10,722,377	32.1%
Washington	27,397,726	25,062,327	22,032,006	25,498,048	31,745,600	37,960,354	36,825,865	34.4%
W. Virginia	754,077	940,642	1,097,937	1,217,925	1,298,817	1,178,228	897,100	19.0%
Wisconsin	5,810,366	6,927,927	8,004,453	8,409,713	9,791,517	9,221,445	9,546,275	64.3%
Wyoming	88,509	95,377	101,206	123,684	175,916	158,404	155,760	76.0%
Puerto Rico	4,365,071	4,618,897	4,704,505	5,188,399	5,528,117	6,126,535	7,893,586	80.8%
Virgin Islands	162,125	158,046	228,591	192,405	242,722	114,478	180,857	11.6%
Unallocated	39,065,166	35,772,636	39,047,625	48,714,210	57,766,857	55,048,520	53,120,060	36.0%

Source: Prepared by Office of Trade and Economic Analysis, International Trade Administration, Department of Commerce. From the Exporter Location Series, U.S. Census Bureau.

Chart 5: International Container Port Rankings

	Port	TEUs
1	Hong Kong	11,265,984
2	Singapore	10,600,000
3	**Long Beach/LA**	**5,091,845**
4	Rotterdam	4,899,879
5	Kaohsiung	4,500,000
6	Busan	3,754,000
7	Kobe	2,787,000
8	Hamburg	2,725,715
9	Yokohama	2,390,629
10	Antwerp	2,250,000
11	New York/NJ	2,169,961

TEUs: Twenty-foot equivalent units
Source: Containerized International and Port Development International

Chart 6: Top-Rated Graduate Schools in Sciences

Top-Rated Graduate Schools in Science	
Biochemistry & Molecular Biology	*Neurosciences*
1 **UC-San Francisco**	1 **UC-San Diego**
2 MIT	2 Yale
3 **Stanford**	3 Harvard
4 **UC-Berkeley**	4 **UC-San Francisco**
5 Harvard	5 **Stanford**
6 Yale	6 Columbia
7 **Cal Tech**	7 John Hopkins
8 Wisconsin	8 Washington
9 **UC-San Diego**	9 **UC-Berkeley**
10 Johns Hopkins/Columbia	10 **Cal Tech**/Rockefeller U.
Bold denotes school in California	
Source: National Research Council, New York Times, 9/13/95.	

Chart 7: Percentage of State Population with Some College Education

California	**31%**
New York	30%
Texas	26%
Florida	25%
North Carolina	24%
Michigan	24%

Source: U.S. Bureau of the Census, Social and Economic Characteristics, 1990 Census of Population and Housing.

Chart 8: Foreign Trade Through California Ports, 1983 to 1999

(in millions of U.S. dollars)

Year	Exports	Imports	Total
1983	29,380	37,944	67,324
1984	32,204	49,270	81,474
1985	32,396	61,606	94,002
1986	32,838	69,875	102,713
1987	39,663	78,478	118,141
1988	53,568	86,605	140,173
1989	63,049	94,080	157,129
1990	68,552	97,122	165,673
1991	73,860	100,744	174,604
1992	81,139	111,548	192,687
1993	82,174	125,348	207,522
1994	95,615	144,002	239,617
1995	116,825	165,045	281,870
1996	124,120	169,981	294,101
1997	131,143	184,684	315,826
1998	116,282	189,943	306,226
1999	122,093	209,025	331,118

Note: Data reflect value of trade through California customs districts and not value of exported goods originating in California or imported goods destined for California.

Source: U.S. Department of Commerce, Department of the Census.

Chart 9: Affiliate Employment and Gross Book Value from Foreign Investment, California and the U.S.

	Employment (jobs)			Gross Book Value		
	U.S.	California	% U.S.	U.S. $ (millions)	California	% U.S.
1982	2,448,062	249,049	10.2	225,235	25,240	11.2
1983	2,546,514	255,551	10.0	244,012	27,601	11.3
1984	2,714,295	274,424	10.1	269,462	31,517	11.7
1985	2,862,153	298,796	10.4	295,181	35,323	12.0
1986	2,937,900	289,171	9.8	320,215	38,321	12.0
1987	3,224,300	334,900	10.4	353,278	44,275	12.5
1988	3,844,200	407,100	10.5	418,069	52,411	12.5
1989	4,511,500	514,900	11.4	489,461	63,706	13.0
1990	4,735,000	555,900	11.7	578,355	75,768	13.1
1991	4,872,200	561,100	11.5	634,688	81,842	12.9
1992	4,706,000	521,500	11.1	660,817	81,067	12.7

Source: State of California, "Foreign Direct Investment In California". November 1994, p.7.

Chart 10: Affiliate Employment and Gross Book Value from Foreign Investment, Top Ten States in 1992

	Employment (jobs)			Gross Book Value	
				($ millions)	
Rank	State		Rank	State	
1	**California**	**521,800**	1	**California**	**84,067**
2	New York	340,000	2	Texas	61,341
3	Texas	324,400	3	New York	43,184
4	Illinois	246,400	4	Illinois	27,680
5	New Jersey	216,300	5	Ohio	24,536
6	Ohio	212,600	6	New Jersey	21,888
7	Pennsylvania	215,300	7	Florida	21,758
8	Florida	1,984,900	8	Alaska	20,946
9	North Carolina	191,300	9	Louisiana	20,757
10	Georgia	154,300	10	Georgia	19,116
	All other states	2,088,200		All other states	315,544
	Total	**4,705,500**		**Total**	**660,817**

Source: State of California, "Foreign Direct Investment In California". November 1994, p.6.

Figure 1

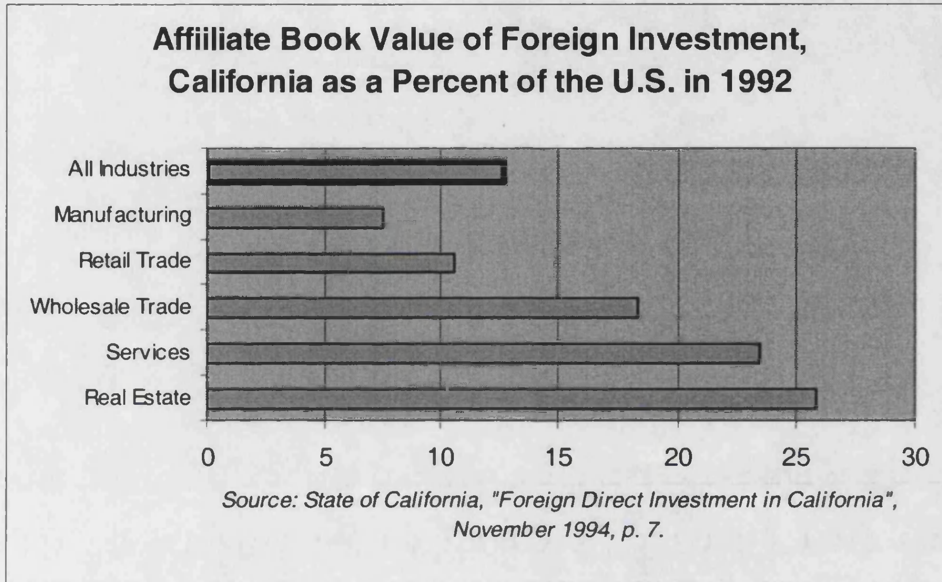

Figure 2

Figure 3

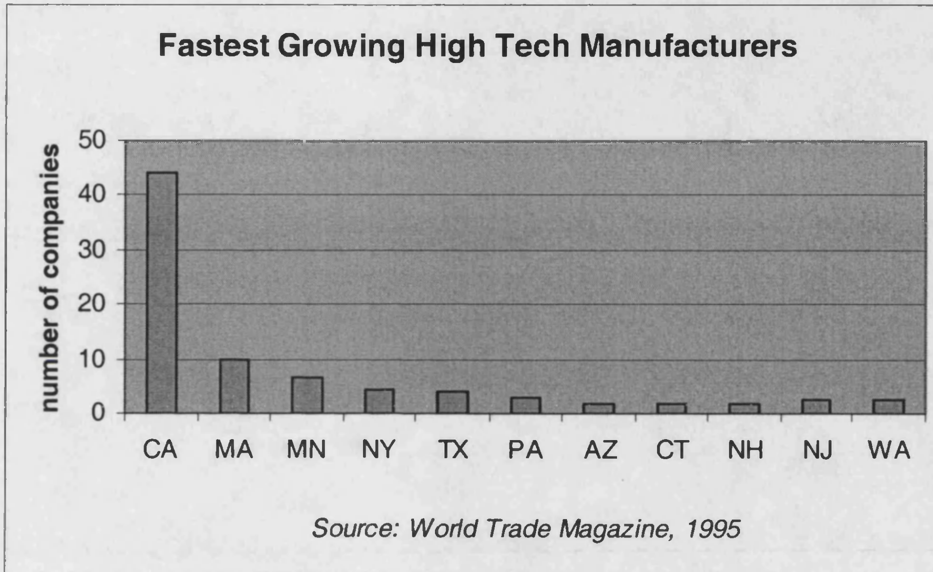

Figure 4

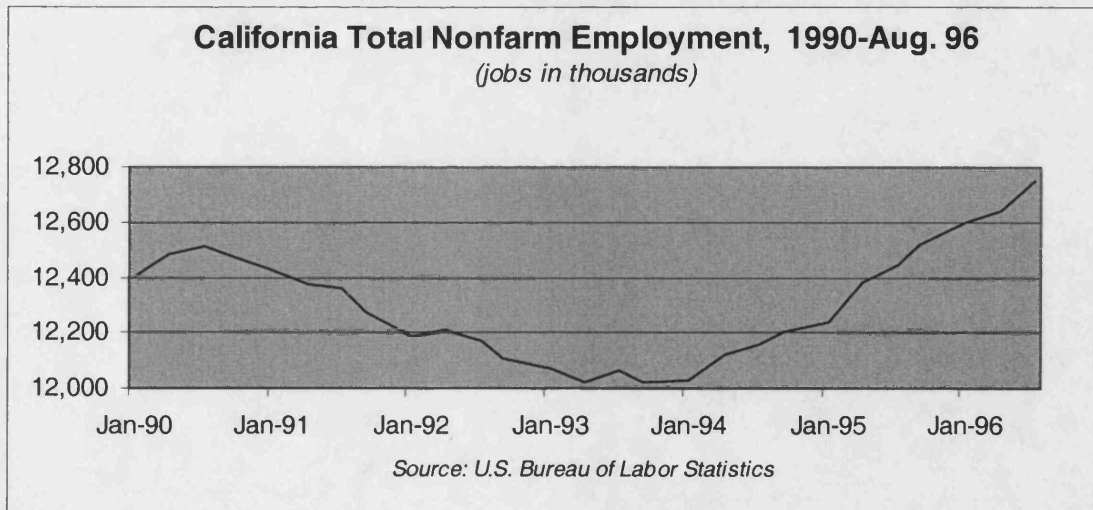

Chart 11: Median Income of Households by State

State	1994-1996
United States	$34,911
Alaska	$50,060
California	**$38,106**
Colorado	$40,971
Connecticut	$43,353
Hawaii	$43,541
Illinois	$38,630
Maryland	$42,582
Massachusetts	$40,695
Michigan	$38,027
Minnesota	$38,554
New Hampshire	$39,016
New Jersey	$45,817
Virginia	$38,787
Wisconsin	$39,877

Source: U.S. Bureau of the Census, March 1997 Current Population Survey.

Chart 12: Total Personal Income in California

Year	California Personal Income	Percent Change
	(millions of $)	
1980	281,589	13.7%
1981	315,375	12.0%
1982	336,098	6.6%
1983	361,589	7.6%
1984	402,979	11.4%
1985	436,898	8.4%
1988	548,302	8.6%
1989	590,962	7.8%
1990	639,298	8.2%
1991	653,172	2.2%
1992	684,674	4.8%
1993	698,130	2.0%
1994	718,321	2.9%
1995	754,787	5.1%
1996	798,580	5.8%
1997	846,839	6.0%

Source: Bureau of Economic Analysis, U.S. Department of Commerce.

Chart 13: Gross State Products (GSP)

(millions of current U.S. dollars)

STATE	1983	1984	1985	1986	1987	1988
U.S. Total	**3,446,583**	**3,866,334**	**4,151,449**	**4,355,877**	**4,683,245**	**5,092,174**
Alabama	45,116	49,741	53,585	56,030	60,722	65,748
Alaska	22,253	23,558	25,870	18,636	22,024	21,353
Arizona	38,252	44,471	49,261	54,615	58,996	63,328
Arkansas	24,976	28,268	29,134	30,430	32,338	34,602
California	**425,811**	**484,068**	**528,950**	**567,025**	**624,022**	**684,452**
Colorado	50,484	56,013	59,034	59,914	63,346	66,720
Connecticut	53,925	61,143	66,540	72,832	81,411	89,707
Delaware	10,409	11,662	13,021	14,099	15,756	17,120
District of Col	24,318	26,420	28,384	30,037	32,398	35,622
Florida	139,617	158,547	173,281	187,870	206,974	226,905
Georgia	77,329	89,373	99,199	108,777	117,803	127,547
Hawaii	16,904	18,541	19,983	21,525	23,404	26,007
Idaho	11,580	12,483	12,979	13,083	13,814	15,036
Illinois	172,250	193,178	206,299	218,381	232,312	250,777
Indiana	67,991	77,600	81,274	85,799	92,174	99,475
Iowa	36,939	41,464	42,851	43,550	45,646	49,210
Kansas	34,844	38,158	40,607	41,418	44,134	46,396
Kentucky	43,196	48,905	51,592	53,452	56,727	61,124
Louisiana	77,788	83,829	85,104	76,197	77,046	83,731
Maine	13,128	14,840	16,071	17,454	19,351	21,666
Maryland	61,836	69,722	76,989	84,111	92,480	102,686
Massachusetts	90,900	103,948	115,110	126,031	139,533	152,304
Michigan	124,902	140,886	151,202	161,005	167,518	178,068
Minnesota	60,586	69,870	74,391	77,853	83,920	90,070
Mississippi	26,205	29,231	30,651	31,433	33,839	36,010
Missouri	66,487	76,039	79,575	85,034	90,422	97,193
Montana	10,677	11,256	11,211	11,257	11,629	11,887
Nebraska	21,288	24,261	25,589	25,971	26,944	29,147
Nevada	15,316	16,908	18,417	20,030	22,156	25,389
New Hampshire	12,692	14,897	16,827	18,701	21,522	23,286
New Jersey	119,087	134,544	146,920	159,622	176,140	197,534
New Mexico	20,564	22,263	23,481	22,539	23,154	24,032
New York	303,353	339,084	366,553	393,523	425,501	462,402
North Carolina	78,385	89,700	98,176	106,263	114,917	126,345
North Dakota	10,187	10,960	10,919	9,975	10,372	9,929

Chart 13 (continued):

(millions of current U.S. dollars)

STATE	1983	1984	1985	1986	1987	1988
Ohio	145,964	165,025	175,958	184,071	193,790	207,460
Oklahoma	47,962	51,914	53,392	48,990	48,820	52,734
Oregon	33,890	37,821	39,923	42,004	45,046	49,715
Pennsylvania	155,212	170,796	180,678	190,765	206,519	224,508
Rhode Island	12,316	13,795	15,182	16,517	17,861	19,722
South Carolina	36,357	41,978	44,672	48,418	53,273	58,124
South Dakota	8,144	9,372	9,831	10,306	10,881	11,375
Tennessee	57,312	64,666	69,260	74,123	81,482	87,872
Texas	271,085	296,938	315,947	299,695	304,826	334,950
Utah	19,878	22,257	24,094	24,453	25,177	27,215
Vermont	6,304	6,970	7,655	8,304	9,284	10,435
Virginia	81,276	92,196	100,692	110,266	121,031	131,755
Washington	65,380	71,086	74,494	80,462	86,898	95,651
West Virginia	20,822	22,758	23,506	23,842	24,534	26,342
Wisconsin	62,895	69,999	74,110	77,967	82,291	89,838
Wyoming	12,212	12,932	13,022	11,224	11,084	11,668
NEW ENGLAND	189,264	215,594	237,386	259,838	288,961	317,120
MID EAST	674,215	752,228	812,545	872,157	948,794	1,039,873
GREAT LAKES	574,002	646,688	688,843	727,222	768,086	825,618
PLAINS	238,476	270,124	283,763	294,107	312,320	333,320
SOUTH EAST	708,380	799,191	858,851	907,101	980,687	1,066,105
SOUTH WEST	377,863	415,586	442,082	425,839	435,796	475,043
ROCKY MTNS	104,832	114,940	120,341	119,930	125,050	132,525
FAR WEST	579,553	651,982	707,638	749,683	823,550	902,568

Chart 13 (continued):

(millions of current U.S. dollars)

STATE	1989	1990	1991	1992	1993
U.S. Total	**5,411,353**	**5,706,658**	**5,895,430**	**6,209,096**	**6,513,026**
Alabama	68,261	71,535	75,930	81,087	84,411
Alaska	22,933	24,773	22,020	22,371	22,842
Arizona	65,938	68,780	71,798	78,930	85,442
Arkansas	36,848	38,415	41,329	44,645	47,177
California	**742,866**	**798,237**	**814,216**	**830,950**	**846,994**
Colorado	70,004	74,649	79,396	85,786	93,553
Connecticut	95,016	98,914	100,373	103,766	107,993
Delaware	19,166	20,282	22,160	23,061	23,755
District of Col	38,183	40,427	42,240	44,458	46,596
Florida	244,303	258,040	269,514	285,177	304,651
Georgia	134,834	141,338	148,627	160,727	171,993
Hawaii	28,801	32,255	33,989	35,532	36,304
Idaho	16,689	17,714	18,627	20,326	22,662
Illinois	264,115	276,451	286,288	303,914	317,896
Indiana	106,898	110,991	114,378	123,833	131,731
Iowa	53,072	56,185	58,140	61,561	63,160
Kansas	48,424	51,555	53,650	56,381	58,416
Kentucky	64,977	67,855	70,785	76,697	80,839
Louisiana	86,670	94,995	95,988	91,315	96,146
Maine	23,060	23,475	23,617	24,374	25,373
Maryland	109,548	114,971	117,600	120,700	126,485
Massachusetts	159,131	159,932	161,488	167,304	175,610
Michigan	186,712	190,700	194,086	206,526	222,734
Minnesota	96,150	100,354	103,858	111,868	115,517
Mississippi	37,669	39,177	41,307	44,217	47,356
Missouri	102,709	104,842	110,446	116,057	119,772
Montana	12,826	13,449	14,088	15,097	16,148
Nebraska	31,237	33,578	35,542	37,598	38,765
Nevada	28,473	31,630	33,652	36,468	39,844
New Hampshire	24,096	23,875	24,941	26,386	27,495
New Jersey	208,345	216,941	224,276	235,423	246,607
New Mexico	25,479	27,151	30,835	32,824	37,021
New York	479,452	502,102	504,533	535,201	551,181
North Carolina	135,983	141,199	147,574	160,116	168,859
North Dakota	10,826	11,675	11,855	12,939	13,103

Chart 13 (continued):

(millions of current U.S. dollars)

STATE	1989	1990	1991	1992	1993
Ohio	219,332	230,121	235,987	250,471	260,853
Oklahoma	54,608	57,716	59,645	61,924	64,749
Oregon	53,522	57,853	60,666	64,297	70,050
Pennsylvania	237,989	249,704	260,425	275,144	287,797
Rhode Island	21,045	21,627	21,753	22,650	23,581
South Carolina	62,245	66,057	68,750	71,911	75,829
South Dakota	12,146	13,068	14,143	15,177	16,347
Tennessee	92,429	95,014	102,028	111,831	119,685
Texas	357,155	388,099	403,261	424,680	452,968
Utah	28,683	31,325	33,626	35,632	38,407
Vermont	11,320	11,750	11,751	12,544	13,140
Virginia	141,748	148,102	153,885	161,704	170,723
Washington	104,758	115,642	122,597	130,772	138,379
West Virginia	27,239	28,290	29,317	30,885	32,217
Wisconsin	95,429	100,434	104,917	112,324	119,510
Wyoming	12,011	13,416	13,532	13,535	14,360
NEW ENGLAND	333,670	339,573	343,923	357,024	373,192
MID EAST	1,092,683	1,144,427	1,171,234	1,233,987	1,282,421
GREAT LAKES	872,486	908,698	935,656	997,068	1,052,724
PLAINS	354,563	371,256	387,635	411,582	425,080
SOUTH EAST	1,133,205	1,190,016	1,245,034	1,320,312	1,399,887
SOUTH WEST	503,181	541,745	565,538	598,358	640,180
ROCKY MTNS	140,213	150,553	159,270	170,376	185,130

Chart 13 (continued):

(millions of current U.S. dollars)

STATE	1994	1995	1996	1997	1998
U.S. Total	**6,930,791**	**7,309,516**	**7,715,901**	**8,240,312**	**8,745,219**
Alabama	89,611	95,341	98,994	104,681	109,833
Alaska	22,769	24,203	24,841	25,512	24,236
Arizona	95,780	104,638	113,099	123,132	133,801
Arkansas	50,817	53,619	56,517	59,116	61,628
California	**878,124**	**924,582**	**971,777**	**1,043,669**	**1,118,945**
Colorado	101,636	109,198	117,470	129,653	141,791
Connecticut	112,588	118,973	124,693	134,792	142,099
Delaware	24,994	27,388	28,704	31,198	33,735
District of Col	47,484	48,399	48,499	50,599	54,100
Florida	325,135	344,381	365,837	391,073	418,851
Georgia	187,153	202,750	218,381	233,773	253,769
Hawaii	36,763	37,259	37,517	38,807	39,712
Idaho	24,773	27,020	27,948	29,086	30,936
Illinois	342,888	359,843	376,489	402,282	425,679
Indiana	141,895	148,642	155,304	163,775	174,433
Iowa	69,611	72,152	77,522	81,574	84,628
Kansas	62,154	63,983	67,972	73,059	76,991
Kentucky	86,850	91,437	95,500	101,445	107,152
Louisiana	105,292	114,105	120,127	127,177	129,251
Maine	26,550	28,087	29,064	30,645	32,318
Maryland	134,066	139,732	145,390	155,008	164,798
Massachusetts	187,755	197,105	209,623	223,483	239,379
Michigan	246,629	253,940	264,848	280,178	294,505
Minnesota	124,986	131,848	141,479	152,340	161,392
Mississippi	51,261	54,398	56,310	59,292	62,216
Missouri	130,099	139,738	146,804	155,243	162,772
Montana	17,023	17,664	18,214	19,060	19,861
Nebraska	42,177	44,302	48,043	49,771	51,737
Nevada	44,842	49,094	54,033	58,488	63,044
New Hampshire	29,393	32,373	35,047	38,137	41,313
New Jersey	257,970	271,297	285,528	303,580	319,201
New Mexico	41,651	42,016	43,825	46,484	47,736
New York	575,671	597,823	634,150	669,446	706,886
North Carolina	182,164	194,514	203,971	220,900	235,752
North Dakota	14,140	14,747	16,089	16,193	17,214

Chart 13 (continued):

(millions of current U.S. dollars)

STATE	1994	1995	1996	1997	1998
Ohio	280,572	295,207	305,559	325,239	341,070
Oklahoma	66,526	69,355	73,893	78,321	81,655
Oregon	75,328	81,301	91,902	98,837	104,771
Pennsylvania	300,540	318,066	328,704	347,169	364,039
Rhode Island	24,254	25,556	26,444	29,175	30,443
South Carolina	81,253	86,484	89,242	94,539	100,350
South Dakota	17,356	18,366	19,534	20,030	21,224
Tennessee	129,541	136,628	141,812	150,728	159,575
Texas	483,591	515,433	555,609	606,901	645,596
Utah	42,295	46,424	51,631	56,062	59,624
Vermont	13,741	13,981	14,679	15,479	16,257
Virginia	179,709	189,003	199,993	213,358	230,825
Washington	146,543	151,469	161,954	176,226	192,864
West Virginia	34,757	36,302	37,237	38,545	39,938
Wisconsin	127,220	133,653	141,037	149,283	157,761
Wyoming	14,871	15,697	17,059	17,770	17,530
NEW ENGLAND	394,281	416,073	439,550	471,712	501,809
MID EAST	1,340,725	1,402,706	1,470,975	1,557,000	1,642,760
GREAT LAKES	1,139,204	1,191,285	1,243,237	1,320,758	1,393,449
PLAINS	460,524	485,137	517,444	548,209	575,958
SOUTH EAST	1,503,543	1,598,962	1,683,921	1,794,626	1,909,142
SOUTH WEST	687,547	731,442	786,427	854,838	908,787
ROCKY MTNS	200,599	216,002	232,322	251,630	269,742
FAR WEST	1,204,369	1,267,909	1,342,025	1,441,539	1,543,572

Source: Bureau of Economic Analysis, U.S. Department of Commerce, prepared by New Jersey Department of Labor, Division of Labor Market and Demographic Research. September 5, 2000.

Chart 14: Affiliate Employment in California, All Countries, by Industry of Affiliate, 1984-1992

Industry	1984	1985	1986	1987	1988	1989	1990	1991	1992
All Industries	**274,424**	**298,796**	**289,171**	**334,900**	**407,100**	**514,900**	**555,900**	**561,100**	**521,800**
Mining	1,175	1,048	1,163	1,500	1,800	5,500	2,700	2,400	2,300
Petroleum	10,705	9,496	8,693	9,700	9,600	10,900	12,400	11,400	8,200
Manufacturing	133,237	150,464	132,689	141,600	173,300	213,900	216,800	210,100	202,000
Food and kindred products	13,861	15,217	16,880	17,500	18,400	27,300	29,000	30,400	30,300
Chemicals and allied products	43,827	53,936	24,883	26,600	28,000	32,700	37,300	34,500	38,600
Industrial chemicals & synthetics	10,277	10,728	11,400	9,800	11,100	11,000	12,500	11,400	14,500
Drugs	5,936	6,676	7,270	8,700	10,000	13,400	14,300	14,300	14,300
Soap, cleaners, and toilet goods	(D)	(D)	5,912	4,900	5,400	7,400	7,400	6,000	6,000
Agricultural chemicals	(D)	(D)	16	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Other	378	446	285	1,900	1,600	900	3,100	2,800	3,800
Primary and fabricated metals	8,979	9,032	10,564	8,200	13,400	20,400	16,500	14,400	12,800
Primary metal industries	4,877	4,691	2,762	4,900	6,700	10,100	8,500	7,700	7,100
Fabricated metal products	4,101	4,341	5,802	3,300	6,700	10,300	8,000	6,700	5,600
Machinery	40,040	40,062	44,563	39,500	52,900	60,900	69,700	66,600	60,200
Machinery, except electrical	11,929	11,210	10,407	11,000	19,000	25,900	29,300	30,400	24,700
Electric and electronic equipment	28,111	28,852	34,056	28,500	33,900	34,900	40,500	36,200	35,500
Other manufacturing	27,031	32,215	35,799	49,900	60,500	72,600	64,300	64,200	12,000
Textile products and apparel	925	935	942	1,200	1,700	3,500	3,900	4,100	3,900
Lumber, wood, furniture, fixtures	1,865	6,400	2,678	1,300	1,900	1,500	2,200	1,500	1,000
Paper and allied products	831	3,460	2,235	2,500	2,600	2,400	3,200	3,700	4,100
Printing and publishing	5,255	6,111	9,253	6,400	7,400	7,500	8,000	8,500	8,400
Rubber and plastics products	3,219	3,162	3,344	2,900	5,000	5,600	5,100	4,500	4,600
Stone, clay, and glass products	5,517	7,356	7,802	13,000	13,500	17,100	16,300	13,500	11,500
Transportation equipment	2,574	4,502	4,340	6,400	7,700	12,000	11,600	12,000	10,900
Instruments and related products	2,260	2,875	3,445	10,800	8,700	10,000	11,000	13,300	12,500
Other	4,585	1,957	1,760	5,500	1,210	1,300	3,000	3,100	3,200
Wholesale Trade	45,850	48,953	49,280	57,500	65,400	74,800	75,400	80,000	81,400
Motor vehicles and equipment	10,443	11,728	10,999	11,400	11,800	11,800	12,100	13,400	13,600
Metals, minerals excl. petroleum	1,477	2,588	2,688	3,599	3,400	3,900	3,700	3,100	2,100
Other durable goods	25,564	26,382	26,646	2,900	5,500	7,100	7,200	8,200	7,800
Farm product raw materials	2,926	1,657	1,308	600	700	1,000	1,000	1,200	1,400
Other nondurable goods	5,440	6,598	7,639	8,900	6,200	6,700	5,600	6,400	8,500

Chart 14 (continued):

	1984	1985	1986	1987	1988	1989	1990	1991	1992
Retail Trade	24,816	26,176	32,206	32,200	48,200	68,000	74,600	77,200	57,100
Food stores, restaurants & bars	4,322	4,588	3,935	3,900	1,900	(D)	(D)	16,100	15,800
Other retail trade	20,494	21,588	28,271	15,700	(D)	35,100	(D)	26,000	26,200
Finance, except banking	5,596	5,688	7,434	8,500	10,100	9,800	4,800	4,900	4,200
Insurance	4,555	5,295	5,237	7,000	12,200	12,700	18,100	19,100	18,900
Real Estate	4,032	4,708	4,488	6,200	6,400	7,500	8,400	6,200	6,900
Services	31,575	35,971	33,363	49,400	53,500	75,800	99,300	105,200	105,100
Other Industries	44,458	46,970	47,981	22,700	28,200	41,600	46,100	47,000	38,000
Agriculture, forestry and fishing	1,583	1,569	1,674	1,600	1,700	2,700	2,100	1,800	2,000
Construction	3,737	3,269	3,385	6,300	5,700	10,000	11,800	10,500	7,100
Transportation	6,900	5,404	5,769	(D)	14,600	17,600	21,700	25,400	19,400
Communication & public utilities	663	757	3,790	(D)	4,600	5,700	7,800	7,000	7,200

D: Supressed to avoid disclosure of data of individual companies. n.a.: not available

Source: Bureau of Economic Analysis, U.S. Department of Commerce. Office of Foreign Investment, California Trade and Commerce Agency. "Foreign Direct Investment in California". February 1997.

Chart 15: Affiliate Gross Book Value of Property, Plants, and Equipment in California, All Countries, by Industry of Affiliate, 1984-92

(millions of U.S. dollars)

Industry	1984	1985	1986	1987	1988	1989	1990	1991	1992
All Industries	31,517	35,323	38,321	44,275	52,411	63,706	75,768	82,334	84,067
Mining	154	253	286	351	477	1,349	851	805	891
Petroleum	(D)	(D)	(D)	(D)	(D)	10,918	11,795	11,758	(D)
Manufacturing	7,545	8,751	9,285	11,245	12,931	15,613	17,697	18,138	20,097
Food and kindred products	740	1,112	1,279	1,473	1,426	1,970	2,333	2,481	2,686
Chemicals and allied products	2,050	2,321	2,022	2,449	2,545	2,716	4,037	4,124	5,145
Industrial chemicals and synthetics	1,135	1,200	1,262	1,503	1,400	1,412	1,574	1,587	2,219
Drugs	328	361	419	509	614	691	1,274	1,485	1,691
Soap, cleaners, and toilet goods	(D)	(D)	(D)	376	426	555	650	691	773
Agricultural chemicals	(D)	(D)	(*)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Other	26	35	(D)	61	104	58	539	361	461
Primary and fabricated metals	619	698	763	983	1,348	1,738	1,887	1,611	1,757
Primary metal industries	416	479	535	829	1,030	1,346	1,282	1,201	1,163
Fabricated metal products	203	219	229	154	318	392	605	510	594
Machinery	1,825	2,145	2,465	2,530	3,343	3,958	4,784	4,622	5,170
Machinery, except electrical	579	568	554	791	1,106	1,555	1,817	2,262	2,453
Electric and electronic equipment	1,246	1,576	1,911	1,738	2,237	2,403	2,967	2,359	2,717
Other manufacturing	2,312	2,476	2,757	3,811	4,270	5,230	4,655	5,291	5,340
Textile products and apparel	10	14	14	81	141	186	107	199	128
Lumber, wood, furniture, fixtures	(D)	(D)	289	(D)	42	36	57	63	65
Paper and allied products	(D)	(D)	(D)	(D)	160	237	279	318	402
Printing and publishing	153	156	351	239	194	296	338	372	512
Rubber and plastics products	116	188	128	122	238	260	302	348	385
Stone, clay, and glass products	1,016	1,070	1,098	1,606	2,013	2,366	1,972	2,161	1,992
Transportation equipment	(D)	(D)	(D)	630	728	993	963	994	1,668
Instruments and related products	44	66	60	494	328	371	489	617	537
Other	220	63	62	216	426	486	148	209	150
Wholesale Trade	1,664	2,112	2,475	2,929	3,744	4,912	6,719	8,242	9,798
Motor vehicles and equipment	593	835	946	1,127	1,466	1,721	2,956	3,851	4,727
Metals, minerals, except petroleum	74	91	105	154	159	219	219	236	231
Other durable goods	739	854	1,002	95	156	382	473	459	428
Farm product raw materials	71	67	56	38	44	55	63	78	121
Other nondurable goods	187	266	366	335	246	359	322	374	487

Chart 15 (continued):

Industry	1984	1985	1986	1987	1988	1989	1990	1991	1992
Retail Trade	618	695	1,326	1,315	1,939	1,799	2,684	3,405	2,521
Food stores, eating & drinking	123	129	82	22	19	(D)	(D)	850	(D)
Other retail trade	495	566	1,244	(D)	(D)	631	729	863	(D)
Finance, except banking	342	493	946	403	245	470	642	883	785
Insurance	188	249	298	281	442	492	776	1,259	(D)
Real Estate	9,123	10,292	10,484	13,045	14,230	17,213	20,853	22,383	23,252
Services	1,228	1,366	1,346	2,915	5,000	6,515	9,036	10,418	10,891
Other Industries	(D)	(D)	(D)	(D)	(D)	5,774	5,566	5,849	4,749
Agriculture, forestry and fishing	429	384	394	393	417	551	695	630	547
Construction	72	78	101	382	275	576	1,646	1,735	1,079
Transportation	175	192	239	517	2,384	2,639	1,426	1,577	881
Communication and public utilities	(D)	(D)	(D)	(D)	(D)	669	949	1,102	1,350

D: Suppressed to avoid disclosure of data of individual companies. n.a.: not available
** Less than $500,000*

Source: Bureau of Economic Analysis, U.S. Department of Commerce. Office of Foreign Investment, California Trade and Commerce Agency. "Foreign Direct Investment In California". February 1997.

Chart 16: Affiliate Gross Book Value of Property, Plant and Equipment in California, by Country of UBO, 1984-92

(millions of U.S. dollars)

Country	1984	1985	1986	1987	1988	1989	1990	1991	1992
All countries	31,517	35,323	38,321	44,275	52,411	63,706	75,768	82,334	84,067
Canada	5,304	5,775	6,100	6,108	7,922	9,463	8,954	8,972	7,092
Europe	17,036	19,130	2,050	21,536	24,591	28,483	34,123	35,443	35,829
Austria	5	(D)	7	(D)	(D)	(D)	167	176	76
Belgium	45	50	98	146	168	100	74	259	257
Denmark	23	28	37	56	59	188	217	269	311
Finland	(D)	8	(D)	8	14	8	37	46	46
France	948	742	848	1,307	1,785	1,858	2,924	3,446	3,800
Germany	1,209	1,650	1,704	2,106	2,497	2,931	4,020	4,085	5,154
Ireland	(D)	(D)	(D)	183	159	262	520	609	646
Italy	(D)	(D)	(D)	109	217	287	332	297	268
Liechtenstein	36	38	51	43	62	176	169	110	178
Luxembourg	(D)	(D)	31	(D)	(D)	120	215	210	225
Netherlands	(D)	(D)	(D)	(D)	(D)	10,767	11,083	10,842	10,866
Norway	(D)	(D)	(D)	(D)	102	117	(D)	(D)	(D)
Spain	25	25	24	51	52	54	55	79	104
Sweden	96	139	136	123	413	558	830	1,080	1,054
Switzerland	611	1,105	1,252	1,065	1,152	1,283	1,835	2,011	2,346
UK	3,914	4,540	4,807	5,681	7,636	9,476	11,437	11,590	10,320
Other	1	1	1	145	(D)	(D)	(D)	(D)	(D)
Latin America/West Hemisph.	1,317	1,373	1,237	1,351	1,452	1,865	2,214	2,168	2,575
South and Central America	514	485	547	589	695	1,071	1,247	1,306	1,441
Brazil	(*)	3	6	(D)	(D)	17	(D)	(D)	(D)
Mexico	95	120	146	152	118	236	303	353	466
Panama	373	303	332	367	497	757	658	653	(D)
Venezuela	9	10	10	27	28	28	31	33	13
Other	37	49	53	(D)	(D)	34	(D)	(D)	55
Other Western Hemisphere	803	888	690	762	757	794	968	862	1,133
Bahamas	39	47	18	129	136	351	111	112	(D)
Bermuda	(D)	(D)	(D)	225	282	305	351	328	458
Netherlands Antilles	639	694	524	377	290	311	306	319	245
U.K. Islands, Caribbean	27	29	31	32	41	61	182	85	336
Other	(D)	(D)	(D)	8	9	9	17	18	(D)

Chart 16 (continued):

Country	1984	1985	1986	1987	1988	1989	1990	1991	1992
Middle East	2,096	2,204	1,969	1,930	2,037	1,909	1,997	2,172	2,163
Israel	1	1	1	1	1	1	4	4	8
Kuwait	1,306	1,315	1,143	1,224	1,240	1,252	1,271	1,373	1,419
Lebanon	50	54	54	17	18	19	21	21	22
Saudi Arabia	363	371	475	384	419	275	306	359	347
United Arab Emirates	186	220	234	(D)	(D)	302	332	350	(D)
Other	189	243	62	(D)	(D)	60	64	65	(D)
Japan	3,907	4,598	57,983	8,464	11,702	17,054	23,060	27,688	30,240
Australia, New Zealand, S. Africa	242	448	681	2,534	1,999	1,262	1,395	1,387	1,341
Other Africa, Asia, Pacific									
Africa, except South Africa	6	20	26	184	167	231	236	273	141
China	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	93
Hong Kong	1,115	1,183	1,175	958	942	1,111	1,412	1,649	1,878
South Korea	64	83	230	494	694	1,005	1,020	1,073	1,106
Malaysia	n.a.	n.a.	n.a.	26	60	29	30	48	90
Philippines	165	181	182	156	160	192	190	207	155
Singapore	n.a.	n.a.	n.a.	197	214	222	229	282	384
Taiwan	n.a.	n.a.	n.a.	39	46	208	466	487	554
United States	42	35	121	147	255	314	161	136	181

D: Suppressed to avoid disclosure of data of individual companies. *n.a.: not available*

* *Less than $500,000*

Source: Bureau of Economic Analysis, U.S. Department of Commerce. Office of Foreign Investment, California Trade and Commerce Agency. "Foreign Direct Investment In California". February 1997.

Chart 17: Affiliate Employment in California, by Country, 1984-92

(millions of U.S. dollars)

Country	1984	1985	1986	1987	1988	1989	1990	1991	1992
All countries	274,424	298,796	289,171	334,900	407,100	514,900	555,900	561,100	521,800
Canada	27,102	30,115	34,846	34,000	60,200	63,800	63,600	63,200	35,900
Europe	155,787	170,152	153,798	174,200	211,000	264,600	290,200	280,200	268,300
Austria	352	357	369	300	2,200	2,200	1,300	1,200	700
Belgium	500	439	1,914	3,500	2,400	1,100	400	1,100	(D)
Denmark	424	457	1,187	1,800	4,100	6,500	(D)	4,500	4,100
Finland	419	433	606	499	600	700	1,600	1,300	1,500
France	17,968	13,452	14,956	17,300	20,100	2,300	28,700	29,000	31,200
Germany	43,514	52,616	24,122	26,900	72,700	30,000	46,100	47,000	48,100
Greece	14	37	20	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Ireland	740	767	198	2,500	2,400	2,400	3,800	3,600	3,900
Italy	376	403	(D)	1,100	(D)	(D)	7,100	4,100	3,200
Liechtenstein	212	230	268	300	600	900	300	300	300
Luxembourg	284	689	722	3,800	4,400	4,400	4,400	4,400	5,400
Netherlands	22,304	20,513	24,873	26,100	27,300	29,800	30,500	25,700	27,300
Norway	(D)	(D)	284	200	200	400	300	200	200
Spain	(D)	(D)	(D)	(D)	(D)	(D)	(D)	(D)	(D)
Sweden	3,879	3,735	4,777	(D)	7,800	8,400	14,400	15,200	12,900
Switzerland	15,946	21,874	22,708	22,200	16,700	31,100	26,400	27,200	28,900
UK	47,329	52,391	53,493	62,200	87,700	116,600	112,500	112,900	97,500
Other	55	57	59	(*)	(*)	(D)	(*)	(D)	100
Latin America/West Hemisph.	15,249	11,398	12,393	1,300	13,700	32,700	17,700	17,500	18,100
South and Central America	5,309	5,156	6,313	6,600	6,900	26,500	10,600	11,500	12,900
Argentina	4	4	5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Brazil	0	0	(D)	300	300	200	(D)	(D)	(D)
Mexico	(D)	(D)	518	1,100	700	(D)	3,700	4,700	5,900
Panama	4,318	4,089	4,377	(D)	4,700	(D)	4,700	(D)	(D)
Venezuela	2	2	5	300	300	300	300	200	300
Other	(D)	(D)	(D)	n.a.	n.a.	700	(D)	800	800
Other Western Hemisphere	9,940	6,242	6,080	6,300	6,800	6,300	7,100	6,100	5,200
Bahamas	(D)	(D)	(D)	200	200	200	100	100	100
Bermuda	232	427	772	3,500	4,300	3,400	4,200	3,300	3,700
Netherlands Antilles	(D)	(D)	(D)	2,500	2,300	2,100	2,000	1,900	1,000
U.K. Islands, Caribbean	393	473	483	(*)	100	600	900	800	300
Other	(D)	(D)	(D)	(*)	(*)	0	0	0	(*)

Chart 17 (continued):

Country	1984	1985	1986	1987	1988	1989	1990	1991	1992
Middle East	6,765	6,091	4,337	1,900	2,700	2,600	1,100	1,100	1,500
Israel	159	218	144	200	200	200	200	200	300
Kuwait	(D)	(D)	(D)	(D)	(D)	(D)	700	500	700
Lebanon	(D)	(D)	300	(*)	0	0	(*)	0	(*)
Saudi Arabia	1,651	971	(D)	400	400	2,200	100	200	300
United Arab Emirates	2	2	2	0	(*)	(*)	(*)	100	(*)
Other	35	130	141	(D)	(D)	(D)	(*)	(*)	100
Japan	54,264	61,216	60,977	71,300	86,600	109,400	134,300	52,400	147,900
Australia, New Zealand, S. Africa	7,797	11,734	13,381	26,800	18,900	24,300	26,100	21,700	19,800
Other Africa, Asia, Pacific									
Africa, except South Africa	46	56	53	(*)	100	300	300	100	(*)
China	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	400
Hong Kong	4,015	4,657	4,670	6,200	5,400	4,900	7,700	9,500	10,200
South Korea	707	832	2,482	2,900	3,200	3,000	3,300	3,400	3,800
Malaysia	n.a.	n.a.	n.a.	100	100	100	100	200	200
Philippines	165	176	186	600	700	(D)	(D)	1,900	(D)
Singapore	n.a.	n.a.	n.a.	200	600	700	1,100	1,100	1,400
Taiwan	n.a.	n.a.	n.a.	600	700	1,000	3,900	3,600	3,200
United States	2,177	2,018	1,684	2,500	2,600	4,000	3,700	3,300	7,000

D: Suppressed to avoid disclosure of data of individual companies. *n.a.: not available*
** Fewer than 50 employees*

Source: Bureau of Economic Analysis, U.S. Department of Commerce. Office of Foreign Investment, California Trade and Commerce Agency. "Foreign Direct Investment In California". February 1997.

Appendix 15: Application of Unitary Methods in Other Countries

Section 1.

Chapter III, Part 4a of the Italian Transfer Pricing Provisions gives the possibility of allocating the overall profits from sales between several associated companies. These profits "are allocated pro rata according to the costs borne by each of the companies involved".[1] The Italian law states that since such a profit split does not take into account either market conditions or the economic holdings of an enterprise, it would only be acceptable under international agreement with a treaty partner.

Para. 13 of the German International Tax Law allows for estimates of income attributable to a domestic entity. "This provision permits the income allocation to be based on a 'normal return on the capital invested in the company' or on the profit on turnover, which can be expected and is customary under the circumstances present. The possibility of profit splits is not specifically addressed in this provision".[2] Paras. 2.4.5 and 2.5.6 of the German Administrative Transfer Pricing Regulations allows the comparisons of profit levels on transactions within the enterprise to profit levels on external transactions in order to verify transfer prices.

Section 2.

Australian subfederal states are not allowed to collect corporate taxes; in Germany, Canada, and Japan, the federal government collects corporate revenue and distributes it to the subfederal levels by a formula; in the U.S., states determine a firm's taxable income themselves using a formulary apportionment method.[3]

The German Trade Tax is also based on a unitary approach, but "the German Trade Tax Law provides for the exclusion from the taxable base of major foreign-source items, such as income attributable to a foreign private enterprise, or dividends received from foreign corporations engaged in active trade or business, provided the domestic enterprise holds a minimum of the shares of the foreign entity...As the trade tax is based

on federal law, the apportionment formula is uniform for the whole country. As opposed to the rather mixed tax environment in the United States, created by the individual state income tax laws which differ in spite of the model recommended in the Uniform Division of the Income for Tax Purposes Act (UDITPA), the aggregate of apportioned tax base cannot exceed 100% of the apportionable tax base for one enterprise, or one group of enterprises joined by fiscal unity, under the Trade Tax Law. The municipalities then apply their individual percentage rate (Hebesatz) to the apportioned tax base. The municipality is free to legislate on this rate within certain limits set by state law, and the constraints of finding an adequate balance between revenue needs and attracting business".[4]

[1] Friedhelm, 1984, p. 107.
[2] Ibid., p. 106.
[3] Hufbauer, 1992.
[4] Friedhelm, 1984, p. 103.

Appendix 16: Interviews

1: Charles S. Nelson
Investment Director
California Trade & Commerce Agency
State of California
27 Dover Street
London W1X 3PA
England
(0171) 629-8211
April 28, 1997

2: Timothy J. McCormally
General Counsel and Director of Tax Affairs
Tax Executives Institute
1001 Pennsylvania Ave., N.W.
Suite 320
Washington, DC 20004-2505
Interview by letter
May 14, 1997

3: J.D. Foster
Executive Director and Chief Economist
The Tax Foundation
1250 H St., NW Suite 750
Washington, DC 20005-3908
202-783-2760
June 4, 1997

4: Willard M. Berry
President
European-American Business Council
1333 H St., NW Suite 630
Washington, DC 20005
202-347-9292
June 4, 1997

5: Christopher J. Mustain
Manager of Government Relations
European-American Business Council
1333 H St., NW Suite 630
Washington, DC 20005
202-347-9292
June 4, 1997

6: Professor Susan Tolchin
School of Business and Public Management
George Washington University
710 21st St., N.W.
Suite 206
Washington, DC 20052
Phone interview
Co-author of Buying Into America, on foreign lobbying in the U.S., which contains a chapter on changes in California's unitary laws.
June 5, 1997

7: Dick Geltman
4125 Leland St.
Chevy Chase, MD 20815-5033
301-656-2470
Worked on the unitary issue at National Governor's Association from 1981-1988.
June 6, 1997

8: Richard M. Hammer
International Tax Counsel
United States Council for International Business
1212 Avenue of the Americas
New York, NY 10036-1689
212-354-4480
Chairman of USCIB Tax Group since 1988; previously, an international tax counsel with Price Waterhouse for 20 years.
June 11, 1997

9: Joseph C. Feuer
Manager, European Affairs/Taxation
United States Council for International Business
1212 Avenue of the Americas
New York, NY 10036-1689
212-354-4856
June 11, 1997

10: Tim Masanz
Director, Economic Development and Commerce Group
National Governors' Association
Hall of States
444 North Capitol St. Suite 267
Washington, DC 20001-1512
202-624-5311
In charge of the lobbying for the National Conference of State Legislatures in 1984/1985; with NGA since 1989.
June 17, 1997

11: James Carter
Organization for International Investment
1901 Pennsylvania Ave., NW
Suite 807
Washington, DC 20006-3405
202-659-1903
Tax Counsel, ICI Americas; UNICE representative.
June 17, 1997

12: Kimberly Pinter, Esq.
Director, Corporate Finance & Tax
National Association of Manufacturers
1331 Pennsylvania Ave., NW
Suite 1500-North Tower
Washington, DC 20004-1790
202-637-3075
June 18, 1997

13: Monica Maguire
Senior Policy Director, Taxation
National Association of Manufacturers
1331 Pennsylvania Ave., NW
Suite 1500-North Tower
Washington, DC 20004-1790
202-637-3076
June 18, 1997

14: Harley T. Duncan
Executive Director
Federation of Tax Administrators
Hall of States
444 North Capitol St., NW
Suite 348
Washington, DC 20001
202-624-5891
With FTA since 1988; previously, a state tax administrator in Kansas from 1983-1988.
June 19, 1997

15: Jim Rosapepe
Rosapepe & Powers
1828 L St., NW
Suite 1010
Washington, DC 20036
202-296-8060
Lobbyist for Multistate Tax Commission.
June 19, 1997

16: Matthew C. Porterfield
Attorney Fellow
Georgetown University Law Center
Harrison Institute for Public Law
111 F Street, NW Room 102
Washington, DC 20001-2095
202-662-9608
Specialist in U.S. state/international legal conflicts.
June 19, 1997

17: Robert K. Stumberg
Professor of Law
Georgetown University Law Center
Harrison Institute for Public Law
111 F Street, NW Room 102
Washington, DC 20001-2095
202-662-9608
Specialist in U.S. state/international legal conflicts.
June 19, 1997

18: Mr. Dan R. Bucks
Executive Director
Multistate Tax Commission
444 North Capitol St.
Suite 425
Washington, DC 20001-1512
Started working for MTC in March 1988; previously,
Deputy Director of Taxes for the state of Montana.
June 20, 1997

19: Mr. John P.Z. Kent
Vice President, Taxes
GTE Corporation
1 Stamford Forum
Ninth Floor
Stamford, CT 06904
Phone interview
Chairman, Taxation Committee, The Business Roundtable.
June 20, 1997

20: Mr. Paul Aurbuck
Attorney
Western Governors' Association
600 17th Street
Suite 1705 South Tower
Denver, Colorado 80202-5452
303-623-9378
Phone interview
June 20, 1997

21: Kendall Houghton
General Counsel
Committee on State Taxation
122 C St., NW
Washington, DC 20001-2109
kendallh@ix.netcom.com
Email interview
July 8, 1997

22: Mr. Sheridan M. Cranmer
Senior Manager
State and Local Tax
KPMG Peat Marwick
725 South Figueroa St.
Los Angeles, CA 90017
213-995-8366
Worked as a state and local and federal tax attorney in
the audit area at Litton Industries from 1988-1997; former
Executive Secretary, California Unitary Tax Council (CUTC).
February 5, 1998

23: Steve Larson
Staff Director
Senate Budget and Fiscal Review Committee
State Capitol
Room 5013
Sacramento, CA 95814
916-445-5202
Previously, Staff Director for California Senator Alfred Alquist.
January 28, 1998

24: Martin Helmke
Tax Consultant
Assembly Committee on Revenue and Taxation
State Capitol
Room 3060
Sacramento, CA 95814
916-445-3808
Previously with Senate Committee on Revenue and Taxation.
January 28, 1998

25: Mr. Richard E. Ratcliff
Applied Strategies
1100 N Street, Suite 5B
Sacramento, CA 95814
916-441-3934
Lobbyist for the Organization for the Fair
Treatment of International Investment (OFTII).
January 29, 1998

26: Lenny M. Goldberg
Lenny Goldberg & Associates
926 J Street, Suite 710
Sacramento, CA 95814
916-446-4300
Lobbyist in favour of the WWC tax method.
January 29, 1998

27: Kathleen Krause
Principal Consultant
Assembly Committee on International Trade and Development
State Capitol
P.O. Box 942849
Sacramento, CA 94249-0001
916-323-8241
January 29, 1998

28: Dan Walters
The Sacramento Bee
2100 Q Street
Sacramento, CA 95816
916-321-1000
Columnist who followed the California unitary tax debate.
January 30, 1998

29: Erick Miethke
Nielsen, Merksamer, Parrinello, Mueller & Naylor
770 L Street, Suite 800
Sacramento, CA 95814
916-446-6752
Attorney for California Unitary Tax Council (CUTC).
January 30, 1998

30: Ralph F. Simoni
California Advocates, Inc.
925 L Street, Suite 350
Sacramento, CA 95814
916-441-5050
Lobbyist for Coca-Cola during the unitary tax debate.
February 9, 1998

31: Fred L. Main
Vice President and General Counsel
California Chamber of Commerce
1201 K St., Suite 1200
P.O. Box 1736
Sacramento, CA 95812-1736
916-444-6670
February 9, 1998

32: David Doerr
Chief Tax Consultant
California Taxpayer's Association
921 Eleventh Street, Suite 800
Sacramento, CA 95814
916-441-0490
Before 1987, Chief Consultant to
Assembly Revenue and Taxation Committee.
February 10, 1998

33: Sandy George
George R. Steffes, Inc.
1201 K Street
Suite 850
Sacramento, CA 95814
916-444-6034
Lobbyist for both corporate and domestic
multinational companies against unitary tax.
February 10, 1998

34: Judi L. Smith
Chief Consultant
Assembly Committee on Revenue and Taxation
California State Capitol
Room 6017
Sacramento, CA 95814
916-322-3730
Deputy to Tim Gage, assistant to Assemblyman John Vasconcellos.
February 11, 1998

35: Dennis Revell
President/CEO
Revell Communications
1121 L St. Suite 806
Sacramento, CA 95814
916-443-3816
Represented Japanese firms in 1983;
lobbyist for California Business Council from 1984.
February 11, 1998

36: Barbara O. Cavalier
Regional Director, State Government Affairs
Abbott Laboratories
1121 L Street, Suite 800
Sacramento, CA 95814
916-443-7464
Lobbyist for California Manufacturers' Association.
February 11, 1998

37: Barry Weissman
Tax Counsel
ARCO
213-486-1440
Phone interview
Member of California Unitary Tax Council (CUTC).
February 16, 1998

38: Kathryn Sommers
Director
Multistate Audit Bureau
Franchise Tax Board
9645 Butterfield Way
P.O. Box 1779
Rancho Cordova, CA 95741-1779
916-845-4169
February 23, 1998

39: Benjamin F. Miller
Counsel, Multistate Tax Affairs
Franchise Tax Board
Legal Branch, MS-B17
9645 Butterfield Way
P.O. Box 1720
Rancho Cordova, CA 95741-1720
916-845-3320
February 10, 1998

40: Brian Bugsch
Policy Analyst
California Trade and Commerce Agency
International Trade and Investment
State of California
801 K Street, Suite 1926
Sacramento, CA 95814-3520
916-445-0171
February 11, 1998

41: Matthew Flynn
Director
Office of Foreign Investment
California Trade and Commerce Agency
801 K Street, Suite 1936
Sacramento, CA 95814
916-323-8021
February 11, 1998

42: James D. Joyce
State and Local Tax Services
Arthur Andersen
Suite 1500
RiverPark Tower
333 West San Carlos Street
San Jose, CA 95110-2710
Director of state & local taxes for Castle & Cook;
chairman of the state legislation committee of COST for 10 years,
member of the tax steering committee for the California
Chamber of Commerce, member of the California Business Council.
408-977-3241
February 25, 1998

43: Terry Ryan
Apple Computer
Coopertino
408-996-1010
February 25, 1998

44: Ray Rossi
Director
External Tax Affairs
Intel Corporation
SC4-206
2200 Mission College Blvd.
Santa Clara, CA 95052-8119
408-765-1193
February 25, 1998

45: Jerry Zanelli
Governmental Advocates, Inc.
1127 11th St. Room 400
Sacramento, CA 95814
916-448-8240
Lead lobbyist for Japanese companies.
February 26, 1998

46: David Nagler
Director of Govt. Affairs for Genentech
980 Ninth St.
Suite 1500
Sacramento, CA
916-443-573
Lobbyist for California Business Council.
February 26, 1998

47: Lester D. Ezrati
General Tax Counsel
Corporate Tax Department
Hewlett-Packard Company
3000 Hanover Street, MS 20BF
Pal Alto, CA 94304
650-857-3962
lester-ezrati@hp.com
Email interview
June 1, 1998

48: Nancy Ordway
Deputy Director, Department of Finance
State of California
Sacramento, California
1983-1987
Federal Budget and Tax Liaison,
Office of the California Governor
Washington, DC.
1987-1991
7041,220@compuserve.com
Email interview
July 30, 1998

49: Denny Valentine
Westinghouse lobbyist and California
Business Council representative, 1985-1987.
Dvalen@aol.com
Email interview
May 11, 1998

50: Ian R. Spence
Director
International Department
UK Inland Revenue
Strand Bridge House
The Strand
London WC2A 1LLB
(0171) 438-6622
May 1, 1998

51: K. Koojman
Head of Group Taxation
Shell Center
York Road
London SE1 7NA
(0171) 934-1234
May 18, 1998

52: Timothy J. McCormally
General Counsel and Director of Tax Affairs
Tax Executives Institute
1200 G Street, NW Suite 300
Washington, DC 20005-3802
(202) 638-5601
Interview by letter
May 14, 1997