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Consultants on Global Issues

Submission to the Trade Sub-Committee of the Joint Standing Committee on Foreign Affairs, Defence and Trade Inquiry into Australia's trade and investment relations with Asia, the Pacific and Latin America

September 30, 2008

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Improving trade and investment performance – removing regulatory impediments

One of the aims of the inquiry is to improve Australia's trade and investment performance.

A central objective of public policy in Australia should be to improve the competitive position of Australian businesses that are exposed to international trade and investment. Removing or reducing domestic policies that impede the exploitation of trade and investment opportunities, both at home and abroad, are the key to economic success in a globalizing world.

Australia currently applies domestic policies that restrict imports and hamper inward foreign direct investment. If these impediments were altered so as to allow increased investment and trade, research shows that GDP could increase by as much as 1.4 percent a year.

Regulation hampers Foreign Direct Investment (FDI) inflows

Current foreign investment policy is given expression by way of the *Foreign Acquisitions and Takeovers Act 1975*. The Act requires foreign investments in excess of certain monetary thresholds to be screened by the Australian Government prior to their execution. In doing so, the Government can simply deny entry to any investor as it sees fit 'in the national interest'. In doing so, it can apply its interpretation without the constraint of law, judicial review, or the need for a transparent explanation.

Last February, the Treasurer announced a set of principles to guide the Australian Government's review of investment proposals by entities owned or controlled by a foreign government. They are likely to increase the restrictiveness of the current regulatory regime, which already costs the Australian economy the equivalent of 0.6 percent of GDP each year.

The new principles mean that the Australian Government will consider the following issues when determining whether an investment proposal is in the 'national interest' and would be allowed to proceed:

1. An investor's operations are independent from the relevant foreign government.

2. An investor is subject to and adheres to the law and observes common standards of business behavior.

3. An investment may hinder competition or lead to undue concentration or control in the industry or sectors concerned.

4. An investment may impact on Australian Government revenue or other policies.

5. An investment may impact on Australia's national security.

6. An investment may impact on the operations and directions of an Australian business, as well as its contribution to the Australian economy and broader community.

ITS Global has recently assessed the implications of these principles for inward foreign investment and for Australia's economic wellbeing. A copy of the report — *Foreign Direct Investment in Australia – the increasing cost of regulation* — is provided as an Exhibit to this Submission.

The principles are likely to restrict investments simply because they are owned or controlled by a foreign government, and not because they represent a clear and present danger to the welfare of ordinary Australians. As China is one of Australia's most prospective sources of inwards foreign investment, the strict application of these principles is likely to adversely affect the broader economic relationship between the two countries, as well as to reduce investment in the Australian economy.

Even before these principles, Australia had one of the most restrictive foreign investment regimes in the world. Of the 43 countries that are monitored by the OECD, only China, India, Russia, Iceland and Mexico have more a more restrictive policy regime. ITS Global estimated that the regime costs the Australian economy at least $5.5 billion a year, which is equivalent to 0.6 per cent of GDP.

Australia's foreign investment regime must be liberalized if Australia is to continue to enjoy the benefits of securing prosperity in the open global economy. Freedom to invest now rivals freedom to trade in economic importance. The same point was made by the Review of Export Policies and Program (the "Mortimer Review") which was recently released by the Hon Simon Crean MP, the Minister for Trade.

Investment performance

In 2007-08 inward foreign direct investment rose to $34.8 billion, equivalent to 3.7 percent of GDP, the highest in 50 years. Outward foreign direct investment rose in 2005-06 to a record high of $30 billion, equivalent to 3.2 percent of GDP. On the present trends Australia will be become a net creditor in the very near future.

Accelerating outward foreign direct investment is a new trend in the Australian economy. This increases the need for more inward foreign direct investment, upon which the Australian economy has always depended to fund growth.

FIRB regulation already costly

Current policy in Australia requires any greenfields investments in excess of $10 million to be screened by the Foreign Investment Review Board (FIRB). Such investments from the US do not have to be screened unless they are worth more than $913 million – this higher limit was negotiated with the US in the US Australia Free Trade Agreement. Agreement has been reached to extend the same level to greenfields investments from New Zealand.

Between 2000-01 and 2006-07, the FIRB reviewed an average of around 5,000 proposals a year and around 7 percent of the applications were withdrawn before screening was completed. Of the investments that were approved, around 30 percent by value had conditions attached to them by the Government.

ITS Global estimates that the deterring and deferral of foreign investment caused by the review process results in losses of foreign direct investment. The opportunity cost of this investment to the Australian economy is around $5.5 billion a year in terms of foregone GDP. This is equivalent to 0.6 percent of GDP.

Appropriate policy

Australia's investment policy should give a clear signal to foreign investors that foreign investment in Australia is welcome

There are two groups of risks to Australia from foreign government ownership or control of inwards investment. One is economic and the other relates to national security.

The economic risks are that an investor would create a monopoly, evade tax, or ignore business regulation to Australia's detriment. The risks are real but the means to address them are well-established and do not discriminate by nationality. All business is subject to Commonwealth and State business law, including the *Trade Practices Act*. There is no basis to expect more, regardless of where the investor is based or who owns it.

While governments have a duty to address any risks to national security, any restrictions on foreign investment should not be more costly or more discriminatory than is necessary and they should not duplicate other regulation. While it is in the interest of both investors and governments to protect sensitive information, the restrictions should be as transparent as possible. Finally, while improper political influence is to be avoided, appropriate parliamentary oversight and judicial review are essential for transparency and accountability.

In particular there is a need for far greater transparency in the definition of 'the national interest' that is to be used in reviewing any foreign investment, as well as in how it is to be applied by the FIRB and the Government. Moreover these should be sufficiently detailed so as to ensure that the Government has to justify every rejection of a foreign investment proposal against them. The same requirement should apply to every

condition placed on those investment proposals that are approved by the Government. In both cases the onus of proof should be on the Government.

The ceilings that apply to investments by US entities should apply to all foreign investors. Otherwise it is a signal to non-US investors (this includes the EU which is the largest source of direct foreign investment in Australia) that they are not welcome.

Maintenance of tariffs imposes a needless cost on the economy

The general tariff applying in Australia is 5 percent, although many imported products enter duty free. The general tariff rate was set in 2000 following a planned, long term reduction of tariffs initiated by the Hawke Government. .

The only exceptions are the tariffs on automobiles, garments and clothing, and textiles, which are currently 10 percent, 7.5 to 10 percent and 15 percent respectively. Existing Government policy has foreshadowed reducing them to 5 percent by 2015. Government reviews have been undertaken on whether or not these tariffs should be reduced further and decisions by the Government are expected shortly. It is essential for both programmes of tariff reductions to continue.

There is no indication the Government plans to review the general tariff rate of 5 percent (Lower tariffs now apply on some products from countries with whom Australia has negotiated a Free Trade Agreement. These are New Zealand Singapore, Thailand and the United States.)

In 2000 the Howard Government considered whether or not to lower the general tariff rate to zero. The Productivity Commission assessed the impact and reported that if tariffs were reduced to zero by 2010 (a target set by APEC which Australia supports) the long-term economic gain would be equivalent to 0.8 percent of GDP.

In a joint statement, the then Treasurer, the Hon Peter Costello MP and the then Minister for Industry, Science and Resources, the Hon Senator Nick Minchin, announced that Australia would keep the general rate at 5 percent and reconsider lowering it as circumstances arose, including trade negotiations. They also observed there was a decade to run before the APEC commitment was reached, which provided plenty of time to meet the APEC commitment.

This has been shown to be poor policy.

It is now 2008. Some tariffs have been reduced with some trading partners, but the majority remains at 5 percent. There was consistently high economic growth over the decade during which the tariff reduction could have been effortlessly achieved.

The failure of other countries to reduce their own tariffs is not a valid reason not to make the Australian economy more productive by removing its remaining tariffs. Their continuation would trap domestic resources of labour, land and capital in less

productive sectors. This is most evident in the automotive, clothing, and textile industries.

Appropriate policy

The Government should decide to reduce Australia's remaining tariffs to zero. This goal should be phased in over a multi-year period to enable industry to adjust gradually, particularly the automotive, clothing, and textile industries.

The impending economic slowdown is not a sensible reason to delay implementing these measures, although it may justify a longer phase-in period, but rather creates a case for pressing on with them. When economies are recovering from a recession, an essential component for a successful recovery is to have previously implemented policy changes that strengthen the international competitiveness of its trade-exposed sectors.

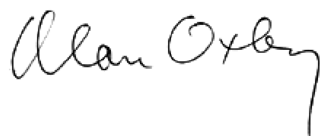
The need to improve competitiveness

A key focus of the Mortimer Review was to assess the international competitiveness of Australian producers and the export performance of the Australian economy.

The Review found it necessary for public policy to improve international competitiveness. In doing so, however, the Review did not address either the economic impact of continuing to keep most tariffs at 5 per cent or the economic cost of the current regime for regulating foreign direct investment.

This submission shows that the economic welfare of Australians could be improved by as much as 1.4 percent of GDP by measures to remove the remaining impediments to trade and inwards foreign investment.

The Joint Committee is respectfully invited to consider these recommendations.



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ITS Global is a public policy consultancy on international issues. It consults to business and government on international trade, aid, environment and development issues. Details are available on www.itsglobal.net

Exhibit 1: Foreign Direct Investment in Australia – the increasing cost of regulation

ITS Global

Consultants on Global Issues

Foreign Direct Investment in Australia – the increasing cost of regulation

Report by ITS Global

9 September 2008

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EXECUTIVE SUMMARY

Strong investment flows in and out of Australia are now more important to economic growth than ever. Flows both ways are at historically high levels and Australian investment offshore for the first time will soon be larger than foreign investment into Australia. This is a healthy development in today's globalized economy and an essential underpinning for continuing economic growth.

To support increasing investment by Australians at home and abroad, we will need higher levels of foreign investment in the future. Yet, recent changes announced by the Treasurer to regulate foreign investment, ostensibly to mitigate the risk of government controlled companies, particularly from China, operating in Australia, are likely instead to reduce foreign investment and limit growth.

It is accepted on both sides of politics that tariff protection in Australia should continue to be lowered. To have an investment policy that goes in the other direction is a policy aberration.

Since European settlement Australia has relied heavily on foreign investment to bridge the gap between domestic savings and the domestic investment that underpins economic growth. This has helped to generate faster economic growth and progressively higher living standards.

Since the late 1980s, inwards investment as a share of GDP has been comparable to the levels of the 1960s. By 2007-08, inwards Foreign Direct Investment (FDI) had reached a five-decade high of nearly 3.7 per cent of GDP, equivalent to $34.8 billion. Over this period, outwards investment has grown more strongly than inwards investment. By 2005-06, outflows had reached 3.2 per cent of GDP and were just under 2.7 per cent in 2006-07, or to around $30 billion.

The increasing tendency for Australian firms to invest abroad has added another dimension to the contribution that FDI makes to Australia's economic growth. This enables Australian firms to become more efficient and competitive in global markets. By expanding their businesses in other markets, they secure resources, expertise and technology.

The emergence of a new group of active investors that are controlled by their governments, such as Sovereign Wealth Funds and State Owned Enterprises, has generated concern in a number of OECD countries, including Australia. These entities are mostly from developing and emerging economies, particularly the oil-exporting nations and China.

Some of these jurisdictions do not observe the standards of government or investor conduct that are common in OECD countries. Others give their public business entities advantages not enjoyed by investors elsewhere. Foreign investment by entities owned or controlled by the governments of such countries raises legitimate concerns about whether the investment will serve their political interests, rather than operate commercially and contribute to economic growth in the recipient countries.

To address this concern the Australian Government has published six policy principles to guide any decisions to permit such government-owned or controlled entities to invest in Australia.

This report demonstrates that these policy principles will most likely simply further politicize the regulation of foreign investment and duplicate controls that already exist. The principles also fail to reflect the OECD principles that are meant to guide the good regulation of foreign investment — regulatory proportionality, predictability, accountability and cost-effectiveness.

Current policy is set out in the *Foreign Acquisitions and Takeovers Act 1975,* which requires foreign investment in excess of certain monetary thresholds to be screened and approved by the Government prior to execution. In doing so, the Government can simply deny entry to any investor it determines not to be 'in the national interest', without the constraint of law, judicial review, or transparency.

The only constraint on the Government's use of these powers is democratic accountability. The result is that decisions on foreign investment become politicised and tend to reflect the views and prejudices of the median or 'swinging' voter, regardless of how much or how little they know about foreign investment or the economic trade-offs that are involved in restricting it. Investment approvals or rejection can be based on peripheral or short-term political interests and can ignore the economic welfare of the whole community.

The pre-existing policy on foreign investment was already unnecessarily restrictive. Of the 43 countries monitored by the OECD, only China, India, Russia, Iceland and Mexico have a more restrictive policy regime. Australia's regime needlessly restricts incoming investment and the nation suffers as a consequence. One third of the foreign investment approved each year has conditions attached to it by the Government. Up to ten percent of applications are withdrawn. The value of the investment opportunities deterred by the approval process is unknown.

We estimate the economic cost to Australia from the foreign investment delayed by the process is substantial and probably at least $5.5 billion a year, which is equivalent to 0.6 percent of GDP.

These new principles are particularly likely to deter investment from China, which is now emerging as one of the most important, new sources of foreign investment, simply because the Chinese economy happens to be dominated by enterprises under government control. They fail in their key role: to distinguish commercial from political objectives underlying any proposed Australian investments.

Since the 1980s, there have been major reforms in every aspect of Australian economic policy. These reforms have opened the economy to the rest of the world and underpinned its unprecedented economic growth. While the tariff wall has been effectively dismantled, however, the moat against foreign investment remains intact. Australia's foreign investment regime must be liberalized if Australia is to continue to secure its prosperity in an increasingly open global economy. Freedom to invest now rivals freedom to trade in economic importance. In contrast, the new policy principles adopted by the Federal Labor Government will facilitate a more protectionist application of the regime that it inherited.

The Government has an obligation to protect Australia's national security interests and its right to do so is enshrined in international law. Restrictions on inwards foreign investment should be limited to just that. It is simply impossible for any government to assess each and every impact of every investment before the event (or even after the event for that matter). The current foreign investment policy regime encourages pre-emptive decision-making on investment opportunities.

Whenever the Government considers restrictions are warranted, the onus should rest on it to demonstrate clearly that they will produce a net economic benefit for the community as a whole. Any restrictions should be as transparent as possible with parliamentary oversight and judicial review to guarantee accountability.

With this in mind, the threshold for investment from the US should be extended to all foreign investors and there should be greater transparency in the detailed rationale for the decisions taken by the Foreign Investment Review Board and the Treasurer.

HISTORY OF FOREIGN INVESTMENT

Since the arrival of European settlers, Australia has relied heavily on foreign investment to bridge the gap between domestic savings and domestic investment. In part, this reflects the country's extensive endowment of natural resources and the highly capital intensive nature of the natural resource industries, such as mining. Moreover, to the extent Australian businesses invest in overseas markets, as they are increasingly inclined to do to exploit economies of scale and scope, will tend to reduce the volume of domestic savings available to fund domestic investment.

Australia taps foreign savings through either by borrowing abroad (foreign debt) or allowing greater foreign ownership of Australian assets (foreign equity). Foreign direct investment (FDI) is one form of foreign ownership. The other principal form of foreign ownership involves portfolio investment in Australian businesses. For official measurement purposes, FDI is regarded as an equity interest of 10 per cent or more in an enterprise.

Any direct comparison between inwards FDI and domestic capital expenditure (investment) is not meaningful in any economic sense. Domestic capital expenditure is always used to create new assets: either new fixed assets (such as plant and equipment, commercial and industrial buildings, and infrastructure) or the accumulation of stocks of finished products and work-in-progress.

FDI can be used either to acquire existing assets or create new ones, but only the latter increases the size of the nation's capital stock. The official data, however, are unable to distinguish between the two forms of FDI. Allowing for that distinction, foreign investment has been a relatively small source of funds for domestic investment. Since the early 1960s, inwards FDI flows have been around 7 per cent of domestic gross fixed capital expenditure.

In the past, inwards FDI flows have followed a similar trend to overall business investment. This reflects the fact that similar economic fundamentals apply to both foreign and domestic investment — such as macroeconomic stability, sound microeconomic policies to promote efficiency and flexibility in product markets, and a skilled and flexible labour market. Consequently, the factors that create a favourable environment for strong growth in domestic investment are also likely to attract foreign investors.

Australia has traditionally drawn on foreign savings to fund higher levels of investment than domestic saving alone would allow. This has helped to generate faster economic growth and progressively higher living standards. As a result, Australia usually runs a current account deficit. Over time, the accumulated current account is the difference between domestic investment and domestic saving.

Trends in inwards FDI

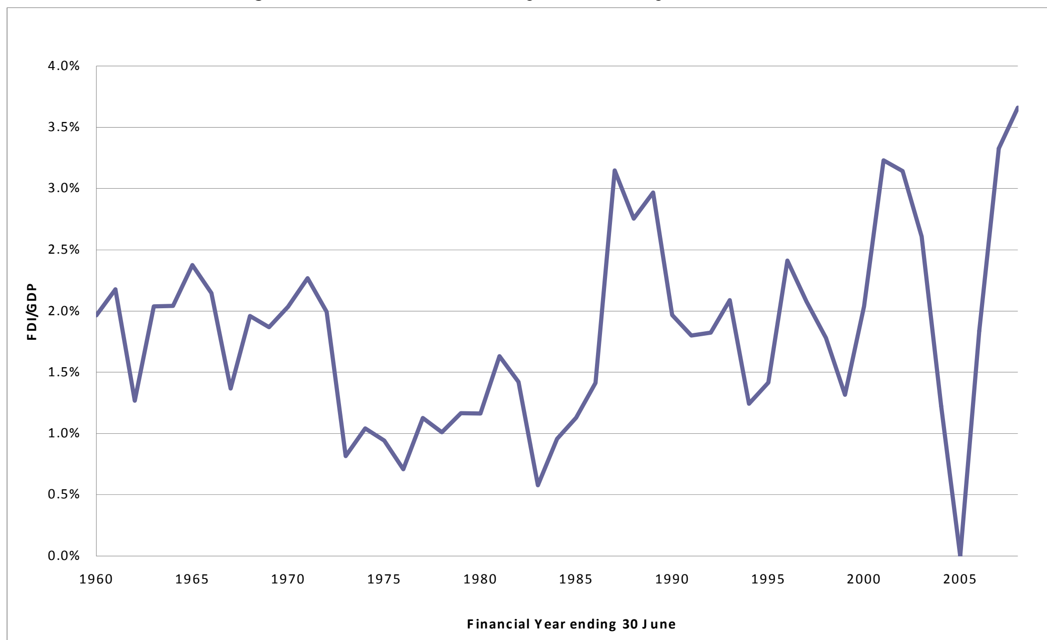
Australia's tendency to persistent current account deficits has meant growing net foreign debt and growing foreign ownership of Australian assets as non-residents contributed to domestic capital formation. The widening in the current account deficit over the 1980s accelerated the build-up of net foreign debt and ownership.[1] From time to time, concern about an 'excessive' build-up in such foreign liabilities has focussed Australian policy makers' attention on boosting domestic saving so as to finance more domestic investment locally.[2]

1 The Treasury,1997, 'Trends in Foreign Direct Investment Inflows', Economic Roundup, Spring, Department of the Treasury, Canberra, pp. 19-25

2 The Treasury 1997

Since the late 1980s, inwards FDI flows as a share of GDP have returned to levels that are comparable to those of the 1960s (see Chart 1). As such, they are significantly higher than they were in either the 1970s or the first half of the 1980s. By 2007-08, inwards FDI had reached a 50-year high of nearly 3.7 per cent of GDP and accounted for a total inflow of $34.8 billion in that financial year.

Chart1: Inwards Foreign Direct Investment, by financial year, as a share of GDP



Source: Australian Bureau of Statistics, 2008a, *Australian National Accounts: National Income, Expenditure and Product*, Cat. 5206.0, Canberra, and Australian Bureau of Statistics, 2008b, *Balance of Payments and Investment Position*, Cat. 5302.0, Canberra

Note: The value for 2005 is not shown as it was negative

Inwards FDI is highly volatile. Depending on the financial years one chooses, inwards FDI can be argued as having grown rapidly from a low of 0.6 per cent of GDP in 1982-83 to the recent high of 3.7 per cent. Another perspective is that inwards FDI has fallen from 3.0 per cent of GDP in 1988-89 to -1.2 per cent in 2000-01 (see Chart 1). Neither perspective presents a balanced picture of what occurred.

The more balanced conclusion is that there is little or no evidence of either a declining trend or an overall weakness in inwards FDI flows over the decades of the 1990s and 2000s compared with the previous decades. The massive drop in 2000-01 was due to an outflow of foreign investment in a single quarter of the financial year (the June quarter, 2001) and is most certainly an aberration, which may safely be ignored when examining the underlying trend over several decades.

When inwards FDI flows reached a historically high proportion of GDP in the late 1980s, it coincided with an unsustainable boom in domestic investment. The subsequent decline has to be seen in that context.

Inwards FDI is also affected by the state of the business cycle. As a consequence, inflows fell as a share of GDP over the period of weaker economic activity during the early 1990s. Since the mid-1980s, net FDI inflows have, on average, represented a smaller proportion of net total capital inflows, than was previously the case. This reflects increased access to debt

financing and the increased attractiveness of the Australian share market. Net portfolio investment in Australia has increased to an average of 3.6 per cent of GDP since the mid-1980s, compared with 1.5 per cent in the previous twenty-five years.[3]

Inwards FDI by sector

While sectoral data on inwards FDI are limited, they do not suggest that FDI inflows go predominantly to any one sector of the economy.

Sectoral data published by the Australian Bureau of Statistics (ABS) on FDI inflows are only available in respect of the 1980s and 1990s. Moreover, these data do not necessarily reflect the final industry destination of the investment. With that qualification in mind, ABS data show that only a relatively small proportion of inwards FDI flows (around 4 per cent) went into the mining sector during the 1990s, in part reflecting the generally low level of world prices for minerals over that period. It is likely that that share has recently increased. The remainder of the inflows has been fairly equally shared among the other sectors of the economy, particularly the manufacturing and financial sectors. The data on the share allocated to the manufacturing sector show no sign of any long-term decline.

An examination of the data published by the Foreign Investment Review Board (FIRB) leads to similar conclusions. The FIRB data relate to foreign investment applications received in the administration of the Australian Government's foreign investment policy. Their reliability as indicators of actual FDI is therefore subject to significant qualification.

The FIRB data indicate brisk growth in foreign investment applications in the manufacturing and service sectors in the four years to 1996.[4] Proposed investment increased more than three-fold in the manufacturing sector (including electricity, gas and water) and over two-and-a-half times in the services sector (excluding tourism). There was a slight fall in the value of proposed investment in mineral exploration and development over this period, although the number of applications increased for that sector.

Some FDI in the 1990s would have involved the partial or full acquisition of existing businesses, particularly as a result of Commonwealth and State privatisation programmes. A distinction is sometimes made between FDI into existing businesses and that involved in establishing new businesses. However, what is crucial for growth of the capital stock is the overall pool of funds available to fund new investment. If FDI involves the purchase of stakes in existing businesses (whether previously privately or government owned), it still contributes to the pool of savings available for investment.

Some attention is given to the fact that FDI in establishing a new business will include an element of technology transfer. While FDI can be a source of technology transfer, this aspect of FDI is more important for developing economies, which lack the economic infrastructure to import technology by other means, than for a developed economy. FDI is a less important channel for technology transfer for industrial countries like Australia — globalisation of the world economy has meant new technologies spread quickly between industrialised countries.

There are likely to be other benefits to Australia from FDI, for example those that flow from importing management skills or improving linkages with foreign markets. However, this does not require that FDI be associated with new projects — FDI directed to the purchase of existing businesses can also have these benefits attached.

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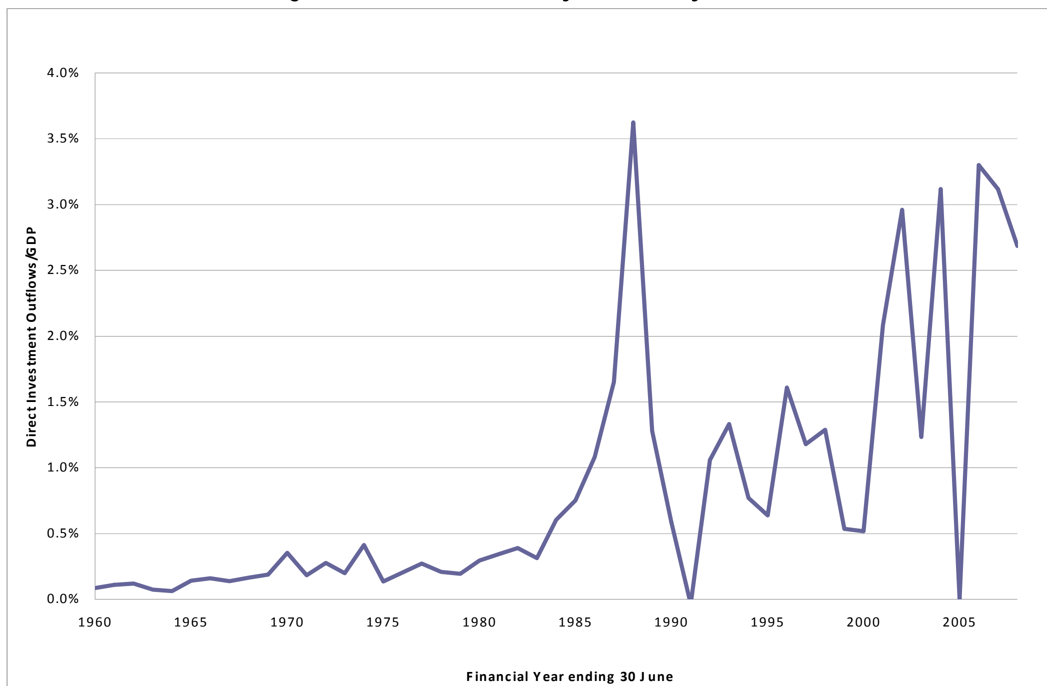
3 The Treasury 1997

4 There are significant differences between the number and value of applications to the FIRB by industry sector. For example around 90 per cent of the applications relate to real estate but most of the proposed investment by value is directed at the rest of the economy.

Trends in Outwards FDI

Over the past 18 years, Australian outward FDI stocks have grown more strongly than inwards FDI stocks.[5] In 1989-90, FDI outflows from Australia were negligible. By 2005-06, they had reached 3.2 per cent of GDP, which was an historical high. In 2007-08, FDI outflows were running at just under 2.7 per cent of GDP and they accounted for a total of around $30 billion (see Chart 2). As is the case with inwards investment, investment outflows are extremely volatile on a year-to-year basis.

Chart 2: Outwards Foreign Direct Investment, by financial year, as a share of GDP



Source: Australian Bureau of Statistics, 2008a, *Australian National Accounts: National Income, Expenditure and Product*, Cat. 5206.0, Canberra, and Australian Bureau of Statistics, 2008b, *Balance of Payments and Investment Position*, Cat. 5302.0, Canberra

Note; The values for 1991 and 2005 is not shown as they were negative

The increasing tendency for Australian firms to invest abroad has added another dimension to the contribution FDI makes to Australia's economic growth. Outwards FDI enables Australian firms to expand their businesses beyond the potential constraints that are imposed on them by the limited size of the domestic market. By extending their market presence and access to resources, expertise and technology in other markets, Australian firms are able to become more efficient and competitive in global markets. Outwards FDI also has a multiplier effect on the domestic economy by stimulating the demand for goods and services provided by component and other input suppliers.

5 FIRB [Foreign Investment Review Board], 2008, *Annual Report 2006-07*, Commonwealth of Australia, Canberra, accessed on 13 August 2008 at http://www.firb.gov.au/content/Publications/AnnualReports/2006-2007/index.asp

Future Importance of FDI to Australia

Expanding FDI flows, both inward and outward, will be important to maintaining the recent high rates of economic growth in Australia into the future. In today's open global economy, the ability to attract investment is more important than ever. Having achieved open global markets for merchandise trade, the capacity of domestic businesses to attract foreign investment and to invest abroad has become increasingly vital to the technological and business innovation that underpins productivity growth and progressively higher standards of living in a medium-sized economy such as Australia.

The major change that has occurred in Australia has been the steady increase in investment outflows. Two-way investment is now much more important. To illustrate the economic significance, in 2004 two-way investment between Australia and the United States (A$46.7 billion) was actually greater than their two-way trade (A$41.7 billion). Investment flows fluctuate significantly, but that this happened at all is indicative of the trend.

The strong growth in cross-border investment flows around the world has been a factor in the recent increase in government-to-government negotiations in multilateral, regional and bilateral forums on investment-related issues. Given the importance of FDI inflows and outflows to Australia and the positive role that international agreements can play in enhancing international investment flows, Australia pursues a broad agenda on investment in international fora. For Australia to create the environment that optimizes opportunities for increased flows of FDI, domestic investment policy needs to be made more liberal.

POLICY ON FOREIGN INVESTMENT

Before 1975, inwards foreign investment was mostly regulated by the Commonwealth Government by way of its foreign exchange controls. Its interventions in this regard were largely *ad hoc*.

In 1975, the Commonwealth formalised its foreign investment policy for the first time. In doing so, it noted that Australia wished to encourage foreign investment "on a basis that recognises the needs and aspirations of Australians". At the time, those needs and aspirations were reflected in a very much more restrictive foreign investment policy than exists today. The policy involved the application of complex tests of the net economic benefit of proposed investments, a preference for Australians to be involved in them as company directors and/or employees and requirements for Australian equity participation in investments in the natural resource industries.

From the mid-1960s to the mid-1980s, foreign exchange controls and foreign investment policy were more restrictive in terms of inwards investment than was the case previously or subsequently. They reflected a perception that foreign investment meant a loss of sovereignty and foreign acquisitions a loss of jobs. In combination with high trade barriers, these restrictions on foreign investment lead to a misallocation of investment and a decline in capital productivity, which has been estimated at around 30 per cent.[6]

Since the late 1980s, there has been a trend away from protection in the design and conduct of economic policy. The reforms have included: liberalisation of foreign investment; the deepening and broadening of economic activity; and, complementary reforms to financial regulation and corporate taxation. The liberalisation of Australia's trade and investment regimes was critical to Australia's historically unprecedented strong rate of economic growth since the early 1990s.

Public policy on foreign investment has to strike a balance between its substantial economic benefits and community concern about foreign ownership. In the majority of industry sectors, smaller foreign investment proposals are exempt from notification to the Australian Government while the larger proposals are approved unless they are judged contrary to the 'national interest'. The Government determines the 'national interest' on a case-by-case basis.

Current policy on foreign investment

Australia's policy on foreign investment is given legislative force by way of the *Foreign Acquisitions and Takeovers Act 1975* and the *Foreign Acquisitions and Takeovers Regulations 1989* that have been made under that Act.[7]

The Act requires foreign investment proposals to be screened prior to their execution wherever they exceed the monetary thresholds specified in the *Foreign Acquisitions and Takeovers Regulations.* The thresholds currently specified are as follows:

- acquisitions of substantial interests in an Australian business where the value of its gross assets or where the proposal values it in excess of $100 million;

6 The Treasury, 1999, 'Foreign Investment Policy in Australia — A Brief History and Recent Developments', *Economic Roundup*, Department of the Treasury, Canberra, Spring, pp. 63-70

7 The following description of Australia's approach to foreign investment policy is drawn from The Treasury, 2008, *Summary Of Australia's Foreign Investment Policy,* Australian Government, Canberra, April, accessed on 13 August 2008 at http://www.firb.gov.au/content/_downloads/General_Policy_Summary_April_2008.pdf

- proposals to establish new businesses involving a total investment of $10 million or more require prior approval;
- portfolio investments in the media sector of 5 per cent or more and all non-portfolio investments irrespective of size;
- takeovers of offshore companies whose Australian subsidiaries or gross assets exceed $200 million and represent less than 50 per cent of their global assets; and
- direct investments by foreign governments and their agencies irrespective of the size of the investments.

As a consequence of the Australia-United States Free Trade Agreement (AUSFTA), the equivalent thresholds are currently set at much higher levels for US entities:

- $105 million for investments in prescribed sensitive sectors or by an entity controlled by a US government; or
- $913 million in any other case.

Moreover, proposals by US investors to establish new businesses in Australia do not have to be notified to the Australian Government — except when the proposal is made by an entity in which the US Federal Government or a US state government has a prescribed interest — but they are subject to all other policy requirements that are relevant to the case in question. In 2006, the *Foreign Acquisitions and Takeovers Act* was amended to provide for higher thresholds for US entities and for the levels in question to be indexed annually.[8] At the time, the Government also took the opportunity to increase the thresholds that apply to investors from other countries to the levels, which are set out in the previous paragraph.[9] Although the Government could have extended the US thresholds to other countries, it declined to do so.

There are extra restrictions on foreign investments in those industry sectors that are considered to be particularly sensitive. At present, the sensitive sectors include banking, civil aviation, airports, shipping, the media, telecommunications, and residential real estate.

In the case of the real estate sector, Government approval is required for proposals to acquire an interest in urban land — including interests that arise via leases, financing and profit sharing arrangements — that involve:

- developed non-residential commercial real estate, where the property is subject to heritage listing, valued at $5 million or more;
- developed non-residential commercial real estate, where the property is not subject to heritage listing, valued at $50 million or more;
- accommodation facilities irrespective of value;
- vacant real estate irrespective of value;
- residential real estate irrespective of value; or
- shares or units in urban land corporations or trusts, irrespective of value.

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8 FIRB 2008

9 FIRB 2008

These restrictions reflect, in part, the fact most foreign investment proposals involve the purchase of real estate. In these cases, the policy aims at increasing the supply of residences while not adding to speculative demand for real estate. The policy does not, however, define what constitutes 'speculative demand'.

The screening process required by the Act allows the Government to review the operations of foreign investors in Australia whenever they propose to establish or to acquire new business interests or property. The process is conducted by the Foreign Investment Review Board (FIRB). The FIRB is a non-statutory body that advises the Government on foreign investment issues and administers the *Foreign Acquisitions and Takeovers Act*. The Treasurer is responsible for foreign investment policy and for making the decisions on individual investment proposals under the Act.

When screening proposals, the FIRB may consult with Commonwealth agencies which have responsibilities that are relevant. Such consultation is conducted on a strictly confidential basis to protect information provided by the proponent. Major proposals usually will be in the public domain and the FIRB takes submissions on them from third parties. The Board's consideration of the submissions is a part of the review process.

In those cases where a foreign investment proposal does not conform to the policy, the Government has the power to block the proposal, or to order the sale of any property that was purchased contrary to its guidelines.

Investments by or on behalf of foreign governments

Investments by foreign governments and their agencies — such as those by state-owned enterprises (SOE) and sovereign wealth funds (SWF) — are meant to be assessed on the same basis as investments by private sector entities.[10] As they are owned or controlled by a foreign government, they raise some additional issues. These reflect the fact that the investors in question may not operate solely in accordance with normal commercial principles but may instead pursue broader political or strategic objectives, which could be against Australia's national interest.

With this in possibility mind, in February 2008, the Federal Treasurer released six principles to enhance the transparency of the screening process in the case of proposed investments by foreign governments or their agencies. The principles require the review of such proposals to consider the following issues:

1. **An investor's operations are independent from the relevant foreign government.**

In considering this issue, the Government focuses on the extent to which the prospective investor operates at arm's length from its government. The published version of the principles, however, are silent as to what, if any, criteria are to be applied in considering this aspect, including any assessment of whether there is a significant difference between the investor's *de facto* and *de jure* independence.

The Government also considers whether the prospective investor's governance arrangements could facilitate actual or potential control by a foreign government, including through the investor's funding arrangements. Where the investor has been

10 Hon Wayne Swan MP, 2008, 'Government Improves Transparency Of Foreign Investment Screening Process', *Press Release*, Press Release No. 009, Treasurer of the Commonwealth of Australia, Brisbane, 17 February, accessed on 13 August 2008 at http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/009.htm&pageID=003&min=wms&Year=&DocType=0

partly privatised, the Government would consider the size and composition of any non-government interests, including any restrictions on governance rights.

2. **An investor is subject to and adheres to the law and observes common standards of business behaviour.**

The Government considers the extent to which the investor has clear commercial objectives and has been subject to adequate and transparent regulation and supervision in other jurisdictions. The available documentation on the principles does not make clear, however, what criteria are to be used or how they are to be applied.

The Government also examines the corporate governance practices of foreign government investors. In the case of an SWF, the Government also considers the fund's investment policy and how it proposes to exercise its voting power in relation to Australian companies.

The Government considers proposals by foreign government owned or controlled investors that operate on a transparent and commercial basis are less likely to raise additional national interest concerns than proposals from those that do not.

3. **An investment may hinder competition or lead to undue concentration or control in the industry or sectors concerned.**

These issues are also examined by the Australian Competition and Consumer Commission (ACCC) in accordance with Australia's competition policy regime, as enunciated by the *Trade Practices Act*.

The published documentation does not elaborate on why a second, parallel assessment by the FIRB is even necessary or what that assessment is meant to add to the one by the ACCC.

4. **An investment may impact on Australian Government revenue or other policies.**

Investments by foreign government entities in Australia must be taxed on the same basis as other commercial entities. They must also be consistent with the Government's objectives in relation to matters such as the environment.

The published documentation is unclear about whether or to what extent this involves taxation, environmental or other obligations that go beyond the requirements of current Commonwealth and State laws in any of these areas.

5. **An investment may impact on Australia's national security.**

The Government considers the extent to which such investments might affect Australia's ability to protect its strategic and security interests.

6. **An investment may impact on the operations and directions of an Australian business, as well as its contribution to the Australian economy and broader community.**

The Government considers any plans by an acquiring entity to restructure an Australian business following its acquisition. Its key interests in this regard include the impacts of the investment proposal on Australian imports, exports, local processing of materials, research and development and industrial relations.

> The Government considers the extent of Australian participation in ownership, control and management of an enterprise that would remain after a foreign investment, including the interests of employees, creditors and other stakeholders.
>
> Again, the published documentation is unclear as to whether or to what extent this involves obligations that go beyond the requirements of current Commonwealth and State laws.

On 24 August 2008, the Federal Treasurer announced the outcome of the Government's first review conducted under these principles. In doing so, the Treasurer approved a proposal by the Aluminium Corporation of China Limited (Chinalco) to acquire up to 14.99 per cent of the shares in Rio Tinto plc.[11] This equates to an interest of around 11 per cent in the Rio Tinto Group as a whole.[12] The Treasurer's approval was conditional on Chinalco neither raising its shareholding without further Government approval nor seeking to have a nominee appointed to the board of the Group.

The international dimension of foreign investment policy

The strong growth in cross-border investment has generated increasing interest in the national treatment of foreign investment in multilateral, regional and bilateral fora. Given the importance of two-way FDI to Australia and the positive role that international agreements can play in enhancing them, the agenda Australia pursues in international forums is generally a liberal one.

Australia has bilateral international investment agreements with 20 countries.[13] The treaties provide for the 'rules of the game' with respect to investment transactions between the parties. Typically, they involve the application of the related principles of National Treatment and Most-Favoured Nation, as well as rules for fair and equitable treatment and protection and security of investors. Investment is also a key feature of many Free Trade Agreements, including the Australia US Free Trade Agreement.

At the multilateral level, there is, as yet, no comprehensive instrument that covers all aspects of foreign investment. An international legal framework, however, is emerging that takes account of both the interests of both foreign investors and the citizens of the recipient countries.

The Australian Government is actively involved with the work of the OECD Investment Committee. The Investment Committee is leading multilateral efforts to develop international rules relating to capital movements, international investment and trade in services. OECD members have established 'rules of the game' for themselves and for the multinational enterprises that operate within their jurisdictions by developing and applying the following 'instruments':

- Codes of Liberalization — The *Code of Liberalization of Capital Movements* and the *Code of Liberalization of Current Invisible Operations* stipulate progressive, non-discriminatory liberalization of capital movements, the right of establishment and financial services, and other current invisible transactions.

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11 Hon Wayne Swan MP, 2008, 'Chinalco's Acquisition of Shares In Rio Tinto', *Press Release*, Press Release No. 094, Treasurer of the Commonwealth of Australia, Canberra, 24 August, accessed on 26 August 2008 at http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/094.htm&pageID=003&min=wms&Year=&DocType=

12 The Rio Tinto Group is a dual listed entity. The Group consists of Rio Tinto plc, which is listed on the London and New York Stock Exchanges, and Rio Tinto Limited, which is listed on the Australian Securities Exchange.

13 A further two agreements have been signed and are in the process of being executed.

- *Declaration* and *Decisions on International Investment and Multinational Enterprises* — The Declaration consists of the following elements, each governed by binding decisions on their implementation:
    - *The National Treatment Instrument*;[14]
    - *Guidelines for Multinational Enterprises*;
    - an instrument on incentives and disincentives to international investment; and
    - an instrument on conflicting requirements.

The OECD Codes of Liberalization are legally binding on all OECD members. All member countries and eight non-member countries have subscribed to the Declaration.

The Codes of Liberalization explicitly recognize the right of countries to protect their essential security interests. Under the Freedom of Investment, National Security and 'Strategic' Industries project, which was launched in early 2006 and endorsed by the G-8 Communiqué of June 2007, the Investment Committee has set out to clarify the concepts of national security and 'strategic' industries, with a view to updating the relevant OECD investment instruments. The project is expected to be completed in 2009.[15]

In parallel, a separate OECD Working Group is looking at the existing OECD guidelines for the Corporate Governance of State-Owned Enterprises. It is exploring the extent to which these may be relevant for Sovereign Wealth Funds (SWFs).

14 'National Treatment' is the commitment by a country to treat enterprises, which operate within its jurisdiction but are controlled by the nationals of another country, no less favourably than domestic enterprises in like situations. The OECD *National Treatment Instrument* addresses the treatment of foreign-controlled enterprises after their establishment and consists of two elements: (1) a declaration of principle, which forms part of the OECD Declaration on International Investment and Multinational Enterprises; and (2) a procedural OECD Council Decision, which obliges adhering countries to notify their exceptions to National Treatment, and establishes follow-up procedures to deal with such exceptions within the OECD (see Directorate for Financial and Enterprise Affairs, 2008, *National Treatment Instrument*, Organisation for Economic Co-operation and Development, Paris, accessed on 26 August 2008 at http://www.oecd.org/document/48/0,3343,en_2649_34887_1932976_1_1_1_1,00.html)

15 The Committee recently released its latest progress report on the project (see Investment Committee, 2008, Freedom *of Investment, National Security and 'Strategic' Industries: Progress Report by the OECD Investment Committee*, Organisation for Economic Co-operation and Development, Paris, accessed on 25 August 2008 at http://www.oecd.org/dataoecd/1/58/40473798.pdf)

DEBATE OVER FOREIGN INVESTMENT

In recent years, the debate over foreign investment in many countries, including Australia, has been given an impetus by the rapid growth in offshore investments by or on behalf of the national governments. Such investments generally involve direct and portfolio investment through so-called Sovereign Wealth Funds (SWFs), as well as mergers and acquisitions involving State-Owned Enterprises (SOEs). The main players in this regard are the oil-exporting countries, such as Norway, Saudi Arabia and Russia, and the rapidly growing economies of East Asia, most notably China.

Although there is no universally agreed definition of a SWF[16], they can generally be thought of as any special investment fund created by a government to hold and manage foreign assets for long-term policy purposes. They can be categorised by either the sources of their funds or their policy objectives.

When classified by the sources of their funds, SWFs can be divided into:

- *commodity funds* that invest the public proceeds from commodity exports, which are either owned or taxed by the government in question; and
- *non-commodity funds* that manage assets transferred from the country's official foreign exchange reserves.[17]

Based on their policy objectives, SWFs may be categorised as follows:

- *stabilisation funds,* such as Russia's Oil Stabilisation Fund, which are used by countries that rely heavily on commodity exports to insulate their economies from the macroeconomic effects of highly volatile world commodity prices;
- *long term savings funds* that transfer wealth between the generations;
- *reserve investment corporations,* such as China's State Foreign Exchange Investment Corporation, which seek to reduce the costs of holding official reserves or pursue higher rates of return;
- *development funds* that finance priority socioeconomic projects, such as infrastructure; and
- *pension reserve funds,* such as the Australia Fund, which finance pension and/or contingent liabilities accruing in the public sector balance sheet.

16 At its broadest, a SWF is any government-controlled fund that manages and invests government revenues, regardless of the source of that revenue. Such a broad definition would, for example, include government pension funds that invest overseas. A narrower definition focuses on public investment vehicles which hold and manage foreign exchange assets separately from official reserves; this is the one preferred by the US Treasury (see Clay Lowery, 2007, 'Remarks on sovereign wealth funds and the international financial system', *Press Release*, Press Release hp-471, Assistant Secretary for International Affairs, US Department of Treasury, 21 June, accessed on 25 August 2008 at http://www.treas.gov/press/releases/hp471.htm). A State-Owned Enterprise, on the other hand, is any business entity that is wholly or majority-owned by central, provincial or local government.

17 Will Devlin and Bill Brummitt, 2007, 'A few sovereigns more: the rise of sovereign wealth funds', *Economic Roundup*, Department of the Treasury, Canberra, Spring, pp. 199-136

A number of the commodity SWFs were originally created to stabilise their government's fiscal position or to sterilise foreign exchange receipts, particularly from oil exports, as an aid to short to medium term macroeconomic management. With the sharp, sustained rise in world commodity prices over recent years, many have evolved into long terms savings funds. In the case of the East Asian SWFs, the key drivers of their evolution have been:

- the substantial and growing foreign exchange reserves accumulated while defending hard (or soft) currency pegs;
- a natural desire for higher returns on foreign exchange reserves to cushion actual and anticipated increases in reserve funding costs; and
- the widening gap between the availability of outstanding bonds in the mature markets for government bonds, such as those in the US and the EU, and the demand from official reserve investors, such as central banks and SWFs.[18]

Although SWFs have been around in all but name since the 1950s, the recent growth in both their size and their number has sparked considerable debate about them and their investment activities around the globe. As their share of cross-border capital flows has accelerated, SWFs have become caught up in the wider debate over global savings and investment imbalances and concerns about the security and stability of the international financial system.

Against that background, the IMF has recently estimated that SWFs have grown from having no more than US$500 billion in funds under management in 1990, to somewhere between US$2 trillion and US$3 trillion in 2007.[19] Although this is a large number on the face of it, one needs to have an appropriate comparator to make sense of the scale of the activities of the funds in question. At the end of 2006, the value of equity and debt securities traded on the world's financial markets stood at US$190 trillion.[20] On this basis, governments around the world only own or control less than two per cent of global securities, which is clearly a trivial share of global wealth.

Moreover, no one government has a dominant position, even in terms of its share of all the publicly owned or controlled securities. The Emirate of Abu Dhabi has by far the largest single public asset holding, which is valued at between US$250 billion and US$875 billion, but the assets in question are managed by two separate entities.[21] For its part, China's State Foreign Exchange Investment Corporation is the fourth largest SWF in the world in terms of funds under management with assets estimated at around US$200 billion.[22]

That said, over the past five years, the size of the global capital market has doubled while the total value of assets held by or on behalf of governments has more than tripled. Although this growth in market share reflects the recent sustained spike in world commodity prices, there are also other factors at work. For example, some SWFs are clearly diversifying their investment portfolios away from domestic securities.[23] From a purely

18 Devlin & Brummitt 2007

19 Simon Johnson, 2007, 'The Rise of Sovereign Wealth Funds', *Finance & Development*, International Monetary Fund, Washington, DC, September, and IMF [International Monetary Fund], 2007, *Global Financial Stability Report: Financial Market Turbulence — Causes, Consequences, and Policies*, International Monetary Fund, Washington, DC, October.

20 IMF 2007, p. 45

21 IMF 2007, p. 48

22 IMF 2007, p. 48

23 Edwin M Truman, 2008, 'The Rise of Sovereign Wealth Funds', *Testimony before the Committee on Foreign Affairs, US House of Representatives*, Peterson Institute for International Economics, Washington, DC, 21 May, accessed on 25 August 2008 at http://www.petersoninstitute.org/publications/papers/truman0508.pdf

financial point of view, any relaxation of the so-called 'home bias' in an investment portfolio makes a lot of sense, regardless of whether it is publicly or privately owned.

As government ownership or control of offshore assets is increasing rapidly, albeit from a very low base, the following concerns have emerged about their implications.

- The investing governments may mismanage their offshore investments. It is a well established fact that governments generally do a poor job of 'picking winners' in their domestic economies, particularly in their pricing of risk and in addressing uncertainty. There is no reason to expect that they would necessarily do better in picking winners in international capital markets. Any losses they incur as a consequence would be borne by their own citizens, rather than those in the recipient countries.

- The investing governments may use the funds to pursue non-economic policy objectives, such as promoting 'national champions' abroad or advancing their political interests in the countries where the assets in question are located or denominated. Such behaviour could raise national security or economic policy concerns for the recipient countries.

- The rapid expansion of offshore investment by foreign governments could encourage calls for greater protection from foreign mergers and acquisitions for the domestic businesses of the recipient countries. This would weaken the market for corporate control in the recipient countries, which would be to their overall economic detriment.

- The investing governments may contribute to global or regional financial instability. There is *ad hoc* evidence that some have invested in highly leveraged investment vehicles, such as hedge funds, private equity firms, and collateralised debt obligations.[24] The opacity of the SWF and SOE operations of many non-OECD countries makes this aspect difficult to assess comprehensively or objectively.

24 Truman 2008

REVIEW OF THE ISSUES

Since the arrival of European settlers, Australia has relied heavily on foreign investment to bridge the gap between domestic savings and domestic investment. In part this reflects the country's extensive endowment of natural resources and the highly capital intensive nature of the natural resource industries, such as mining.

Foreign capital has allowed Australians to enjoy higher rates of economic growth and employment as well as higher standards of living than could have been achieved had they been forced to rely solely on their own savings.

Inwards foreign investment comes in a number of guises — short and long term debt, portfolio equity investment and foreign direct investment (FDI). Of these, FDI is normally the most stable as it generally involves a substantial commitment by the investor in acquiring business assets and hiring staff, whereas debt finance and portfolio investment can be recalled relatively quickly. An example of this is the recent Asian financial crisis that resulted in a deficiency of short-term debt finance, but did not have a significant impact on the level of foreign direct investment in the Asian region.[25] Also, the return to direct investment is dependent on profitability, unlike debt finance where the capital and interest must generally be repaid, regardless of performance.

FDI increases competitiveness by exposing local management to international standards and best practice. It also brings technological benefits through the establishment of new businesses, or the modernisation of old ones. Accordingly, the economy emerges better able to provide high-productivity and well-paid jobs into the future.

Restrictiveness of the policy

Some have suggested that, following the most recent liberalisation in foreign investment policy in Australia, the process of reviewing proposed foreign investments is no longer particularly restrictive.

Such a conclusion is often rationalised by reference to the low rate of rejection of foreign investment applications submitted to the Foreign Investment Review Board (FIRB), as measured by the value of the proposed investment foregone as a consequence of rejection. Each year, the Treasurer rejects around 100 foreign investment applications made to the FIRB and executes a small number of divestiture orders. Most of the rejections involve the real estate sector.[26]

Since 2000-01, an average of 1.3 per cent of proposed investments by value has been rejected by the Government following the review process, although rejections tend to be highly volatile and relatively infrequent.[27] Table 1 has the year-by-year details of the investment applications made to the FIRB and the outcomes from the FIRB review process.

25 Treasury 1997

26 FIRB 2008

27 The FIRB recently changed how it manages the information that it uses to report the outcomes of the review process. As a consequence, the published data for the period up to 30 June 2000 is not comparable to the period since 1 July 2000 (FIRB 200?).

Table 1: Foreign investment applications considered & decided, 2000-01 to 2006-07

Outcome of Foreign Investment Application to FIRB	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	Average
No. of investment applications submitted to FIRB	3,858	5,097	5,315	5,036	4,884	5,781	7,025	5,285
Share of applications exempt from provisions of FA&T Act	5.0%	3.4%	3.8%	4.1%	3.7%	3.2%	2.8%	3.6%
Share of applications withdrawn from FIRB review	8.2%	7.9%	6.9%	6.3%	5.9%	6.5%	9.0%	7.3%
No. of investment applications decided by FIRB review	3,347	4,523	4,747	4,511	4,415	5,223	6,196	4,709
Proposed investment for applications decided by FIRB review ($ billion, current prices)	116.0	118.0	85.8	99.1	119.5	85.8	156.4	111.5
Share of proposed investment rejected by review process	8.4%	0.1%	–	0.1%	–	–	–	1.3%
Share of proposed investment unconditionally approved by review process	69.0%	59.5%	62.4%	60.4%	50.5%	84.5%	89.7%	68.8%
Share of proposed investment conditionally approved by review process	22.7%	40.4%	37.5%	40.5%	49.5%	15.5%	10.3%	30.1%
Proposed investments as a share of GDP	16.8%	16.0%	11.0%	11.8%	13.3%	8.9%	14.9%	13.1%

Source: FIRB [Foreign Investment Review Board], 2006, *Annual Report 2005-06*, Commonwealth of Australia, Canberra, and FIRB 2008.

The conclusion that the process is not particularly restrictive is misplaced for two reasons.

- A number of investment applications to the FIRB are never fully assessed, as they are withdrawn from the review process by their proponents before the applications can complete the process.
- Some investments that would be commercially justified in the eyes of the potential investors are never put forward to the FIRB for a formal review.

The FIRB annual reports throw a little light on the first group. They revel that, from 2000-01 to 2006-07, an average of just over seven per cent of investment applications were withdrawn before the review process could be completed. The information published by the FIRB does not, however, reveal either the reasons for the withdrawals or the ultimate fate of the proposed investments. For example, some may be subsequently revised and resubmitted to the FIRB for consideration and eventually complete the review process. The rest of the withdrawn applications, no doubt, are dropped completely by their proponents.

Unfortunately, the data published by the FIRB on the outcomes of the review process do not shed any direct light on the extent of the second group of investments. This is unsurprising, given the significant collection and measurement difficulties involved in doing so.

The extent of any foreign investment, which is foregone at any stage of the review process, is clearly an important issue for public policy in Australia, given that domestic savings have traditionally been insufficient to fund its domestic investment needs and are now

increasingly being invested offshore. Loss of investment is, however, inevitable given the transaction costs prospective investors confront in putting an investment application to the FIRB and responding to its queries.[28]

The transaction costs involved in making a FIRB application include:

- professional services fees — for example for legal, accounting, investment and operational advice — involved in preparing an application of any consequence;
- opportunity costs of the time and effort of investors, their executives and their staff in preparing the application and participating in the review process; and
- highly uncertain outcomes for the prospective investor from the review process.

These costs mean the rational foreign investor has to assess the net return they expect to receive from any prospective investment, *prior* to committing any resources to the preparation of an initial application to the FIRB. This assessment should take account the opportunity cost of the resources involved in preparing such an applications, as well as the subjective probability of the Government approving the proposed investment on terms and conditions acceptable to the investor.

If the prospective investor expects the net return from an investment opportunity in Australia to be greater than what they can expect to obtain elsewhere, they will proceed with the preparation of the FIRB application. If the expected return on the Australian opportunity is less than the alternative investment, the prospective investor will pass up the opportunity, even if it is intrinsically sound from a purely business perspective. The nature of such foregone opportunities means they are not readily evident, particularly to politicians and voters, but they are very real nonetheless.

The uncertainty involved in the investor making such an assessment is considerable and can have a powerfully negative effect on most investors' willingness to proceed. This reflects the uncertainty about what does and does not constitute Australia's national interest as far as foreign investment is concerned — this issue is taken up substantively in the next section of this Chapter. The extent of the uncertainty is such that there are probably investment opportunities that could well be approved by the Australian Government but never get to be considered due to the miscalculation of the prospective investors and their natural aversion to such uncertainty.

A prospective investor's decision to proceed with a FIRB application, however, is merely the start of the review process and its impacts on investment. Investors will, as far as is feasible from their business perspective, tend to modify how they structure their proposed investments so as to improve their chances of Australian Government approval. They will also regularly review the decision to apply to the FIRB and update their evaluation of the net worth of the Australian investment opportunity in the light of new information, both as a consequence of their interaction with the review process as well as more generally.

Again, the uncertainty, which is involved in foreign investors making accurate assessments of these things, is considerable due to the profound ambiguity surrounding the definition of the Australian national interest and its practical application. As Table 1 shows, some 30 per cent of the foreign investments approved by the Australian Government under the *Foreign*

28 The *Foreign Acquisitions and Takeovers Act* provides that decisions under the Act are to be made within 30 days and allows a further 10 days for interested parties to be advised of a decision. The review period may be extended for up to 90 days. Applicants may also be allowed additional time to information required by the FIRB and interested parties may be given time to address issues arising from a proposal. Proposals that are not subject to the Act are handled under the policy but are not subject to the statutory deadlines (FIRB 2008).

Acquisitions and Takeovers Act have terms and conditions imposed on the investments by the Government, if they are to proceed.

All of this means there are likely to be foreign investment losses at every stage of the review process, compared to what would have happened in the absence of the *Foreign Acquisitions and Takeovers Act*.

At a time when Australians are investing an increasing share of their savings abroad, the loss of any foreign investment almost certainly represents a reduction in overall investment in the domestic economy. Other things being equal, any reduction in domestic investment means slower productivity growth and a future standard of living lower than it would otherwise be. In other words, imposing restrictions on foreign investment has a very similar impact on the domestic economy as imposing restrictions on foreign trade.

A key public policy issue is how big the economic losses for the Australian economy can be expected to be. The following evidence suggests they are likely to be significant.

- The policy imposes a delay on all inwards foreign investment that is subjected to review.[29] Such delays represent a permanent and ongoing cost to the domestic economy. The cost is the return foregone on the investment approved by the Government over the period of the delay. Based on 2006-07 data, we estimate the economic cost of the delayed investment is around $4 billion a year.[30]

- Over seven per cent of investment applications to FIRB are withdrawn before the review process is completed. The FIRB does not publish details of either the applications that are subsequently resubmitted in a modified form or the investment that is permanently foregone as a consequence of withdrawal. Based on 2006-07 data, we estimate the economic cost of withdrawn investment could be as high as $1.5 billion a year.[31]

- Some 30 per cent of the investments approved by the Government have restrictions placed on them. The restrictions vary considerably but generally relate to ensuring or preserving the Australian character of the business being established or acquired. Given the absence of information on the economic consequences of such restrictions, it is difficult to estimate the economic benefits and costs.

- An unknown number of prospective investment opportunities are never even considered by the Australian Government. These cases do not generate an application to the FIRB due to the subjective assessments by investors of the low probability of success for a given investment application and the significant time and effort in preparing an application to the FIRB. Unfortunately the complete lack of information on such cases means it is virtually impossible to estimate the economic costs of the foreign investment that is completely suppressed by the nature of Australia's foreign investment regime.

29 In 2006-07, 90 per cent of investment proposals were decided within 30 days of their receipt by the FIRB, compared with 92 per cent in 2005-06 (FIRB 2008). The FIRB does not publish details of the average time taken by it to decide investment proposals, weighted by the value of the proposed investment. This is likely to be significantly longer than the median decision time, which the FIRB also does not publish.

30 This estimate is based on inwards approved investment of $156.4 billion in 2006-07 and an assumed weighted average delay of three months for each approval, weighted by the value of the proposed investment. The Social Opportunity Cost of the capital foregone by the delay is assumed to be 10 per cent a year.

31 This estimate assumes that the average value of the investment in withdrawn applications is equivalent to the average value of approved applications, that all withdrawn applications are never resubmitted, and that the Social Opportunity Cost of capital is 10 per cent a year.

The restrictiveness of Australia's policy regime has been confirmed by the OECD, which has developed an index to measure the restrictiveness of national regimes for regulating inwards FDI.[32] The OECD FDI Regulatory Restrictiveness Index covers nine industry sectors[33] in 43 countries.[34] Primarily it measures the deviations from 'national treatment' imposed by policy— i.e. the extent policy discriminates against foreign investors compared to domestic ones — rather than the absolute extent the restrictiveness of the regulatory environment on investment more generally.[35]

The methodology developed by the OECD is a variation of that used by the Productivity Commission for a study of inwards FDI restrictions in the APEC economies.[36] Each of the regulatory restrictions in the OECD Index is weighted by its severity — with the scale ranging from zero (no restriction) to one (complete prohibition). The heaviest weights are reserved for foreign equity restrictions and the lightest for screening and approval processes. Due to the somewhat arbitrary nature of these weights, the OECD Index does not consistently measure a country's attractiveness to inwards FDI but, in combination with other known explanatory factors, it has proved to be very useful in assessing national policies on foreign investment.[37]

The latest results published by the OECD indicate Australia is among the most restrictive countries, both within the OECD as well as outside it, as far as inwards FDI is concerned. Of the 43 countries that have been assessed by the OECD to date, only China, Russia, India and Iceland have regulatory regimes more restrictive on inwards FDI compared to Australia. Recent research at the OECD has shown that were Australia to remove these restrictions, its stock of inwards foreign investment would increase by nearly 50 per cent over the longer term.[38]

Ambiguity of 'the national interest'

Australia's foreign investment policy is explicitly founded on the superficially reasonable notion of the national interest. The concept of the national interest, however, is open to a very wide range of interpretations to such a degree that there is no generally agreed definition of it in either common or academic usage.[39] It is not possible, therefore, to

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32 The latest results are to be found in OECD, 2007a, *International Investment Perspectives: Freedom of Investment in a Changing World*, Organisation for Economic Co-operation and Development, Paris, accessed on 20 August 2008 at http://www.oecd.org/document/32/0,3343,en_2649_33763_39398368_1_1_1_1,00.html. A detailed discussion of the methodology is in Stephen S Golub, 2003, 'Measures of Restrictions on Inward Foreign Direct Investment for OECD Countries', *OECD Economic Studies*, 36(1), pp. 85-116

33 The industry sectors covered by the Index are business services (legal, accounting, architectural, and engineering services), telecommunications (fixed line and mobile telephony), construction, distribution, finance, (insurance and banking), tourism, transport (air, maritime and road transport), electricity and manufacturing.

34 The countries covered by the Index are: the 29 OECD member countries; the ten non-OECD countries that adhere to the OECD *Declaration on International Investment and Multinational Enterprises* (Argentina, Brazil, Chile, Egypt, Estonia, Israel, Latvia, Lithuania, Romania, and Slovenia); and four others (China, India, Russia and South Africa).

35 Regulations that apply equally to foreign and domestic investors are not considered, with the exception of state monopolies. The Index takes into consideration barriers to entry in the form of limitations on foreign ownership and special screening procedures, as well as post-entry management and other operational restrictions. The restrictions can apply to all or only selected sectors.

36 See Alexis Hardin and Leanne Holmes, 1997, *Service Trade and Foreign Direct Investment*, Productivity Commission Staff Research Paper, 27 November, and Alexis Hardin and Leanne Holmes, 2002, 'Measuring and Modelling Barriers to FDI', in Bijit Bora, (ed.), 2002, *Foreign Direct Investment: Research Issues*, Routledge, London

37 Giuseppe Nicoletti, Stephen S Golub. Dana Hajkova, Daniel Mirza and Kwang-Yeol Yoo, 2003, 'The Influence of Policies on Trade and Foreign Direct Investment', *OECD Economic Studies*, 36(1), pp. 7-83

38 For the purpose of this analysis, the baseline stock level was defined in terms of 1998 (see Nicoletti et al 2003)

39 For example, the *Wikipedia* defines the national interest as 'a country's goals and ambitions whether economic, military, or cultural' and, in doing so, observes that 'As considerable disagreement exists in every country over what is or is not in "the national interest" , the term is as often invoked [in international relations] to justify isolationist and pacifistic policies as to justify interventionist or warlike

distinguish the concept objectively from related concepts, such as ‘the public interest’, ‘the interest of the state’, ‘national welfare’, or ‘community welfare’.

Notwithstanding the central importance of the concept of the national interest to Australia’s approach to foreign investment, the *Foreign Acquisitions and Takeovers Act* does not provide a definition of the ‘national interest’. Instead, the Act delegates that function to the Government to decide on a case-by-case basis. In doing so, however, the Act provides no guidance to the Australian Government or the FIRB about how ‘national interest’ is to be defined, let alone applied to applications by foreign investors. In this respect, the Act adds nothing of value to the process of assessing foreign investments and does not, in any practical way, constrain the Government in how restrictive or liberal it may be in restricting inwards foreign investment.

The FIRB has been equally silent on the issue. Apparently it does not publicly comment on how it applies the concept in assessing foreign investment proposals and in framing recommendations to the Government on them. For example, there is no discussion of these issues in FIRB annual reports, despite the fact that they are central to its mission. Indeed, the FIRB regularly opposes requests under the *Freedom of Information Act* from members of the public for additional information on foreign investment matters under its jurisdiction. It generally justifies its opposition on the grounds of protecting commercially confidential information that has been provided by prospective investors.[40]

In such an environment the only substantive constraint on the Government’s handling of foreign investment issues is the requirements for democratic accountability, as expressed thorough the Australian Parliament. This makes all foreign investment issues inherently political. In other words, foreign investment policy will tend to reflect the views of the median voter, regardless of how much the median voter knows about foreign investment or the economic trade-offs that are involved in restricting it.

For prospective investors, political uncertainty is the hardest form of uncertainty for them to address. There are several reasons for this.

- Political uncertainty is qualitatively different to other forms of uncertainty investors and business people have to contend with. For example, its adverse consequences can be far more extreme, given the coercive power the state has at its disposal

- Unlike most commercial uncertainties, political uncertainty and its determinants are largely outside the day-to-day experience of most investors and business people. This ignorance is exacerbated by any impediments to the transparency of the political processes that can impinge on foreign investment decisions.

- Given the complex and diffuse nature of political uncertainty, it is completely outside the ability of most prospective investors and business people to manage in any practical way.

- Finally, there is generally little scope for investors to insure against the adverse consequences of political uncertainty.[41]

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policies.’ (See The Wikipedia Foundation Inc, 2008, ‘National interest’, *Wikipedia*, 30 July, accessed on 20 August 2008 at http://en.wikipedia.org/wiki/National_interest)

40 The FIRB handed two requests under the *Freedom of Information Act* in 2006-07 and five in 2005-06. In one of the former cases, the applicant sought a review of the decision to refuse access to the information in question thorough the Administrative Appeals Tribunal; the appeal was eventually settled out of court (FIRB 2008).

41 Most of the insurance against sovereign risk is underwritten by the governments of some developed countries, and even then, only in respect of certain exports by their nationals to developing countries, which are considered to represent the highest sovereign risks.

As a consequence, most investors exhibit a high degree of aversion to political uncertainty. For this reason, regulatory regimes that involve a relatively high degree of such uncertainty are much more restrictive of foreign investment. While successive Australian Governments have significantly liberalised some aspects of foreign investment policy, the heavy reliance that continues to be placed on the concept of 'the national interest' remains the least liberal component of the current policy stance and is inconsistent with the direction of policy reform that has occurred in other areas of economic policy.

Overreaction to foreign government involvement

The rapid economic growth of China and a number of other developing countries in Asia has been based on strongly export-orientated manufacturing sectors. These developments have been of enormous economic benefit to Australia, given its well-established position as an internationally competitive supplier to countries in the Asian region of many basic raw materials, such as liquefied natural gas, coking and streaming coal, iron ore, and bauxite.

Australia's economic prospects have been enhanced by the strong rise in world commodity prices over the past three or four years. These price hikes have, however, also tended to erode the competitiveness of downstream manufacturers and heighten concerns about the security of raw material supplies. In a number of cases, the recent developments have led to an increased interest, on the part of downstream users, in upstream investments to improve security of raw material supply, as well as to provide a natural 'hedge' against adverse commodity price movements.[42]

These are normal commercial responses to the developments in question. In the case of China, however, its user industry sectors are generally dominated by large State Owned Enterprises (SOEs). If such an entity were to propose a merger or an acquisition involving Australian businesses or assets located in Australia, it would trigger the application of the six review principles enunciated by the Treasurer last February — and which were outlined earlier (see pages 8 and 9 of this paper).

This raises the question as to whether these principles are appropriate to the task of assessing the implications of foreign government ownership or control in the sort of situations Australia is most likely to confront. In Australia's case, these situations are most likely to involve Asian countries, such as China, which have fundamentally different notions of the role of government and of the private sector than is the case in Australia and other OECD countries.

The short answer is that the principles announced by the Treasurer are not appropriate to evaluating such cases. Their application is highly likely to result in the Australian Government turning down substantial foreign investments that would have benefited Australia.

The following discussion outlines the reasons for this conclusion by examining each principle in turn.

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42 A hedge is a financial transaction that is undertaken specifically to reduce the risk inherent in some other transaction. For example, a hedger would invest in security that he believes is under-priced compared to its longer term value and would simultaneously short sell a related security. The hedger is now indifferent to price changes in the market as a whole but is only interested in the performance of the under-priced security relative to the hedge. A natural hedge is one that occurs naturally for the hedger, such as borrowing in the same currency in which its sales are denominated, and excludes the use of financial derivatives.

1. Investor independence

In the present circumstances, the strict application of the requirement of investor independence would almost certainly cause any economically significant merger or acquisition proposal by a Chinese SOE to fail.

Any such failure would largely reflect the current state of institutional evolution in China as it continues the transition from a centrally planned to a market economy that it begun in 1978. At the present time, property rights in China are very weak; its judicial system is highly politicized; and executive and legislative transparency is generally poor. The State maintains tight control of the financial sector and directly or indirectly owns all the banks. Investment is highly controlled and regulated.[43] In such an environment there is little basis for concluding that a major investment decision in a foreign country by a Chinese SOE could be taken without at least the tacit approval for the Chinese Government. This is widely believed to have been the case even for the proposal by Chinalco to acquire a relatively minor stake in the Rio Tinto Group.[44]

In such circumstances, the real issue is not the independence of the investing entity but the nature of the objectives of its owner in letting or having its entity make the acquisition. If the reasons are essentially commercial and are expected to remain so, there would seem to be little point for Australia to worry about the independence of the SOE. The main policy concern for a recipient country should be to enhance the transparency of the decision-making processes of the investing Government.

2. Adherence to common legal & business standards

For the reasons outlined in previous discussion, it seems unlikely any Chinese SOE would be able to demonstrate it had clear commercial objectives or was subject to particularly transparent regulation and supervision at home. That does not mean, however, that they should not be allowed to invest outside of their home country or that such investments would be necessarily harmful to the prospective host countries.

Nevertheless, the SOE reforms China has implemented so far have been an unqualified success. In 1998, China had 5.6 million SOEs. They accounted for 80 per cent of all enterprises, employed 122 million people and produced 57 per cent of non-farm gross domestic product (GDP).[45] By 2006, the role of the State in the economy had shrunk dramatically and there were only 1.8 million SOEs employing fewer than 76 million workers and producing around only 35 per cent of non-farm GDP.[46]

In reforming its SOEs, China has deliberately avoided the 'shock therapy' of rapid privatisation applied in the former Soviet Union. Rather, China has kept key sectors in State ownership. The Chinese Government has, however, clarified the formal objectives of its SOEs, streamlined the legislative regimes for regulating business and the agencies that administer them, broken up each of the sectoral monopolies into multiple competing

43 Kim R Holmes, Edwin J Feulner, and Mary Anastasia O'Grady, 2008, *2008 Index of Economic Freedom*, The Heritage Foundation and Dow Jones & Company Inc, Washington, DC and New York, NY

44 See for example: Paul Murphy, 2008, 'Rio Tinto, Chinalco and the road to "cast magnificence"', *The Financial Times,* 1 February, accessed on 25 August 2008 at http://ftalphaville.ft.com/blog/2008/02/01/10643/rio-tinto-chinalco-and-the-road-to-cast-magnificence/; Dexter Roberts and Chi-Chu Tschang, 2008, 'Why Chinalco's Buying Into Rio Tinto', *Business Week*, 5 February, accessed on 25 August 2008 at http://www.businessweek.com/globalbiz/content/feb2008/gb2008025_188402.htm; and Michael Sheridan, 2008, 'Beijing shows its hand in Rio Tinto grab', *The Sunday Times*, 10 February, accessed on 25 August 2008 at http://business.timesonline.co.uk/tol/business/industry_sectors/natural_resources/article3340925.ece

45 Gabriel Wildau, 2008, 'Albatross turns phoenix', *China Economic Quarterly*, 12 (2), Dragonomics Advisory Services Ltd, Beijing, June, pp. 27-33

46 Wildau 2008

businesses, given SOE management and staff incentives to improver financial performance, including thorough employee ownership, and allowed foreign investors to buy into SOEs.[47]

While the operational performance of Chinese SOEs has definitely improved since these reforms were implemented by the State-Owned Assets and Administration Commission (SASAC), they are still not as efficient as their private sector counterparts. The gap in efficiency is substantial and there is no evidence that it has narrowed over time.[48] Moreover, it is unclear how much further SOE reform will be undertaken in the future.

Perhaps more importantly, transparency has not improved to anywhere near the same degree. Most Chinese SOEs operate thorough opaque holding entities and it is generally impossible to determine the exact ownership structure of Chinese business corporations, including those that claim to be privately owned.[49]

Once again, the real issue is the nature of the objectives of the owner of the SOE to invest offshore. If the reasons are essentially commercial and are expected to remain so, there would seem to be little point in the prospective host countries opposing the proposed investments subject to the observance of their laws and business standards.

3. Implications for competition

The competitive implications of any merger or acquisition, which involves at least one business that operates in Australia, are clearly important from a public policy perspective. For this reason, all such transactions are subject to the provisions of the *Trade Practices Act,* which, among other things, prohibits any merger or acquisition that is likely to reduce competition in a market in Australia, unless they are shown to have some offsetting public benefit. This is the case regardless of who owns the Australian businesses or assets involved in the transaction or where in the world those owners happen to reside.

The ACCC enforces the *Trade Practices Act*. As a consequence, it reviews mergers and acquisitions before the event and may authorise potentially anti-competitive transactions, provided it has assessed them as generating an offsetting 'public benefit'. Although 'public benefit' is not defined by the Act, the courts tend to allow it to have a broad meaning. Nevertheless, the Act explicitly extends the meaning to both a significant increase in the real value of exports and a significant substitution of domestic products for imported goods.

As all acquisitions by foreign investors, including those owned or controlled by a foreign government, are subject to the full provisions of the *Trade Practices Act* and comprehensive examination by the ACCC, it is not clear why the FIRB should undertake a second, parallel assessment of the competitive implications as proposed by the published principles.

Doing so simply imposes additional compliance costs on prospective foreign investors and additional administration costs on the Australian Government for no obvious benefit for the Australian community. Moreover, of the two review processes, that by the ACCC is to be strongly preferred: it has to be undertaken against the requirements of Australian competition law; its review process is more transparent than that of the FIRB and is protected from political influence; and all decisions taken by the ACCC are subject to judicial review in Australian courts.

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47 Wildau 2008

48 OECD, 2005, *OECD Economic Surveys: China*, Organisation for Economic Co-operation and Development, Paris

49 Barry Naughton, 2008, 'Profiting the SASAC way', *China Economic Quarterly*, 12 (2), Dragonomics Advisory Services Ltd, Beijing, June, pp. 19-126 and Arthur Kroeber, 2008 'Where the state is still king', *China Economic Quarterly*, 12 (2), Dragonomics Advisory Services Ltd, Beijing, p 24

4. Implications for tax & other policies

Clearly, all foreign businesses operating in Australia should be expected to observe all Australian laws. This includes any obligations to pay the taxes, fees and charges levied by every level of government and to comply with appropriate Commonwealth and State regulation, such as environmental protection.

The obligations in this regard, however, should be no more onerous than those imposed on locally-owned businesses. Should existing Australian legislation fail to implement this principle in an even handed fashion, the best solution is to correct the anomalies at their source rather than to refuse entry to particular investors or particular investments.

In other words, there is no sound argument for the Australian Government making any approval required under the *Foreign Acquisitions and Takeovers Act* conditional upon an assessment of these issues.

5. Implications for national security

Sovereign governments clearly have a right, not to mention an obligation, to protect national security. Recent international arbitral decisions have confirmed the existence of such rights *vis-à-vis* foreign investors under customary international law.[50] International investment instruments — such as the *OECD Code of Liberalisation of Capital Movements* — as well as bilateral and regional investment agreements to which most countries are a party — including those to which Australia is a signatory — allow a degree of freedom for governments to judge their national security requirements for themselves.[51]

It is, however, in the interests of all countries to limit the restrictions they place on inwards foreign investment to those cases where their security and other essential interests are clearly at stake. The imposition of excessive impediments to cross-border mergers and acquisitions is likely to impose significant costs on both countries, including the one responsible for imposing them, and could lead to retaliatory action by the other country, which would simply exacerbate the economic losses for both parties.

OECD governments have agreed that a sound policy regime for foreign investment needs to be based on the principles of regulatory proportionality, predictability and accountability.[52] Any restrictions governments place on inwards foreign investment should not be more costly or any more discriminatory than is necessary. Moreover, they should not duplicate other regulation that could do the job better. While it is clearly in the interest of both investors and governments to protect sensitive information, the restrictions should be made as transparent as possible. Finally, while improper political influence is to be avoided, parliamentary oversight and/or judicial review is essential for appropriate democratic accountability.

6. Implications for Australian business, the economy & the community

On the face of it, this 'catch-all' category is designed to cover anything that the Government might want it to cover. It gives the impression that its role is to provide government with a rationale for refusing to approve an investment proposal without having to disclose its real reasons for doing so.

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50 OECD, 2007a, 'Essential Security Interests under International Investment Law', *International Investment Perspectives: Freedom of Investment in a Changing World*, Organisation for Economic Co-operation and Development, Paris, pp. 93-134

51 OECD 2007a

52 OECD, 2007b, 'Freedom of Investment, National Security and "Strategic" Industries: An Interim Report', , *International Investment Perspectives: Freedom of Investment in a Changing World*, Organisation for Economic Co-operation and Development, Paris, pp. 53-63

This reflects the fact that every investment project can be expected to have a negative impact on some groups in the community. Every new investment will bid resources away from other businesses, at least over the short term, and will increase the extent of competition with those businesses that produce close substitutes. The purchase of an existing business can lead to legitimate and economically sensible cutbacks in labour or other resource use to improve profitability.

To avoid this trap, each and every impact of a proposed investment by or on behalf of a foreign government would have to be assessed before the Government approves it. At a practical level this is clearly impossible. No person or organisation could possibly know the nature and the extent of every impact an investment could be expected to have now and into the future.

In the case of an arms length transaction between the willing Australian seller of a business or asset and a willing foreigner buyer — whether privately or publically owned or controlled — Australian policy should focus solely on the implications for the welfare of the community as a whole, to the exclusion of every other consideration.

Given the severe information constraints all public policy necessarily confronts, the Government should allow all transactions to proceed in the absence of a clear and precise demonstration that:

- it would reduce community welfare compared to what would otherwise have been the case; and/or

- preventing the transaction from proceeding or requiring its terms to be modified would increase community welfare.

CONCLUSIONS

The debate over investment in Australia by State Owned Enterprises and Sovereign Wealth Funds, particularly from China, has resulted in a review of foreign investment policy by the Rudd Government that is likely to further restrict economic growth in Australia.

While regularly described by a long line of Treasurers as liberal, Australia's foreign investment regime is rated by the OECD is the sixth most restrictive of the 43 economies it monitors (only China, India, Russia, Iceland and Mexico are more restrictive). We estimate the regime inherited by the Rudd Government probably costs Australia a minimum of $5.5 billion a year, equivalent to 0.6 percent of GDP.

Since the 1980s there have been major reforms in every aspect of economic policy in Australia. These reforms have opened the economy to the rest of the world and underpinned unprecedented economic growth. While the tariff wall has been effectively dismantled, however, the moat against foreign investment remains intact.

The Australian Government can simply deny entry to any significant investor 'in the national interest', without the constraint of law, judicial review, or a transparent explanation. Every 'greenfield' investment of more than $10 million has to be reviewed by the Foreign Investment Review Board and approved by the Treasurer. Conditions are attached to 30 percent of proposed investments by value.

Private sector investments from the US of up to $913 million in non-sensitive sectors of the economy are notably exempt from the foreign investment review and approval process. This was agreed in the recent Free Trade Agreement with the US and to date the Australian Government has declined to extend equivalent treatment to other foreign investors.

Concerns about foreign investment are rising in a number of countries, including Australia, with the emergence of a new group of active investors from developing and emerging economies that are owned or controlled by their governments. When such investors are based in countries that lack appropriate standards of conduct, or enjoy unfair advantages from government, there are legitimate concerns about the state of the global playing field. On the other hand, any discrimination against foreigners strikes at the heart of international trade and investment on which countries like Australia depend for their prosperity.

As the analysis in this report shows, the six principles that govern investment by government-owned or controlled entities, as recently announced by the Federal Government, are likely to further restrict domestic investment. Moreover, they do so simply because the entities in question are owned or controlled by a foreign government, rather than because they have been shown to represent a clear and present danger to the welfare of Australians.

The six principles are therefore likely to reduce economic growth in Australia, not just because of the deterrent effect of the transaction costs of the approval process, but because the decisions made as a consequence of them will necessarily restrict investment from China, which is emerging as a major source of foreign investment for Australia. The principles do not get to the nub of the substantive policy issue — how best to tap the foreign savings that are essential for Australia's economic development, while minimising the risks of exploitation by a foreign power.

There are two groups of risks to Australia from foreign government ownership or control of inwards investment. The first group is economic and the other relates to national security.

The economic risks are that the investor would create a monopoly, evade taxes, or ignore business regulation to Australia's detriment. The risks are real but the means to address them are well-established and do not discriminate by nationality. All business is subject to Commonwealth and State business law, including the *Trade Practices Act*. There is no basis to expect more, regardless of where the business is based or who owns it.

While governments have a duty to address any risks to national security, there is no generally agreed approach within the international community. Any restrictions on foreign investment should not be more costly or more discriminatory than is necessary and should not duplicate other regulation. While it is in the interest of both investors and governments to protect sensitive information, the restrictions should be as transparent as possible. Finally, while improper political influence is to be avoided, parliamentary oversight and/or judicial review are essential for democratic accountability.

Australia's foreign investment regime must be liberalised if Australia is to continue to enjoy the benefits of the global economy. Freedom to invest now rivals the freedom to trade in economic importance. Australian business needs to be able to take advantage of both inward and outward foreign direct investment. The current costs to economic growth of the existing system of regulation will increase as the importance of freedom of movement of foreign direct investment increases.

At a minimum, the threshold for investment from the US should be extended to all foreign investors and there should be greater transparency in the decisions taken by the Foreign Investment Review Board and the Treasurer.