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# Executive Summary

Australia has always been dependent on foreign investment to build infrastructure, grow industries and jobs. If Australia wants to attract investment in a capital constrained world, it must be an attractive destination. Yet Australia currently has one of the most restrictive foreign investment regimes in the world, and that applies especially for investments from State-owned entities (SOEs).

The rise of investment applications to the Foreign Investment Review Board from SOEs has prompted concerns about the motivations of such investments and whether the government should block these applications.

To provide clarity, in February 2008, the Federal Treasurer, Wayne Swan, outlined six additional principles to apply to investments by State-owned entities. But there is an inconsistency between the perception of risk and the reality of risk posed by SOE investment.

SOE investments do not pose a threat to Australia's national interest. The risks posed by SOEs flow from the special treatment they enjoy from close proximity to domestic government. But the special treatment enjoyed in their domestic economy does not extend extraterritorially. For example, a Chinese SOE may enjoy beneficial arrangements in China, but the powers of the Chinese government do not extend to Australia, and nor do the benefits the SOE enjoys.

In Australia an SOE only enjoys the same commercial environment as any other investor. And the Australian government maintains the right to appropriately regulate where there may be a perceived risk from an external SOE investor. For example, the government can do so by ensuring that the standards of corporate governance for firms listed on the Australian Stock Exchange are rigorous and prevent large controlling shareholders from looting the firm's assets or expropriating firm value from minority shareholders. Given appropriate corporate governance standards, large controlling shareholders need not pose any investment threat or any other type of threat to Australia. With appropriate shareholder protection all investment would be in the national interest.

Australia also needs to come to grips with the realities of new sources of investment, especially SOEs. As investors they are not unique and are subject to market scrutiny, as are other forms of investment.

Rather than fearing investment from SOEs, the Australian government should be:

- ensuring the appropriate legislative and regulatory frameworks are in place to ensure investors act appropriately; and
- liberalising the Australian investment regulatory regime to ensure Australia is an attractive destination for investment capital.

Developing Australian infrastructure, Australian industry and Australian jobs is in the Australian 'national interest'. To fulfil these objectives Australia needs investment capital. With the correct regulatory and legislative regime in place the origins of the investment is irrelevant.

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# Table of contents


| Section | Title | | Page |
|---|---|---|---|
| 1.0 | **Introduction** | | **5** |
| 2.0 | **The contemporary investment environment** | | **6** |
| *2.1* | *The international investment environment* | *6* | |
| *2.2* | *Australia's place in the international investment environment* | *7* | |
| 3.0 | **Australia's already restrictive investment regime** | | **9** |
| *3.1* | *More regulation, more politicisation, less investment* | *11* | |
| 4.0 | **The risk of sovereign wealth funds?** | | **13** |
| *4.1* | *Is the risk real?* | *14* | |
| 5.0 | **Liberalisation is the best reform** | | **17** |
| 6.0 | **Conclusions** | | **19** |
| 7.0 | **Reference list** | | **20** |


***Abbreviations***

| | |
|---|---|
| EU | European Union |
| FDI | Foreign direct investment |
| FIRB | Foreign investment review Board |
| OECD | Organisation for Economic Cooperation and Development |
| SOEs | State-owned entities |
| SWFs | Sovereign wealth funds |
| UNCTAD | United Nations Committee on Trade and Development |
| US | United States |

# 1.0 Introduction

Recent bids by state-owned entities (SOEs), or companies owned by SOEs, for equity or ownership of Australian companies and assets has prompted political outcry about the intentions of the acquisitions. As a result, alarmist rhetoric and political hyperbole has entered the national debate about the risks of allowing SOEs to invest in Australia without extensive scrutiny.

The Foreign Investment Review Board (FIRB) is charged with scrutinising foreign investment in Australia over a certain dollar value. FIRB applications are assessed based on an opaque 'national interest test', before a final decision by the Treasurer on each application. Because of the perceived risk of acquisitions by SOEs the Commonwealth Treasurer, Wayne Swan, introduced an additional test in early 2008 to further scrutinise investment stakes by SOEs. But the addition of the test was motivated more by political expediency, than evidence-based concerns.

This submission will assess the current position of the international investment environment, Australia's position in it and how regulation affects Australia's investment environment in the global context. The submission will then assess the legitimacy of concerns about SOEs as investors in Australia. In particular this submission will look at the political and economic risks, the concerns that underlie them and assess whether they have a legitimate basis. Finally the submission will propose options for reform to promote Australia's investment interest based on the perceived threat from SOEs.

# 2.0 The contemporary investment environment

The global economy is in a precarious position. The United States (US) economy is mired in financial problems that first emerged in subprime mortgage lending, but has now spread much more broadly throughout its financial sector.

Other countries are feeling the effects of the US economic contagion – including through tighter international credit markets, and weak business and consumer sentiment, translating into recessions amongst many of the traditional suppliers of investment capital. Australia is facing contradictory economic pressures. The government has now declared a recession 'inevitable' against continuing growth (though reduced in comparison to comparatively recent high rates of growth) in many of Australia's major Asian trading partners.

These events may have an important effect on foreign investment flows going forward, presenting new challenges and opportunities for Australia in attracting foreign direct investment (FDI) in the future.

## *2.1 The international investment environment*

A more unstable macroeconomic environment is having a negative effect on global investment plans. This could lead either to investors restricting their plans only to projects with the highest returns, or the cancelation or deferral of investments. Alternatively, a more uncertain macroeconomic environment could encourage investors to invest in 'safe haven' locations with the best guarantee of an economic return.[1]

Important insights into the FDI outlook can be gleaned from an annual survey of global investment conditions by the United Nations Conference on Trade and Investment (UNCTAD). The latest World Investment Prospects Survey gauges expected foreign investment patterns for 2008-10, and is based on a sample of 5,000 multinational companies. The survey findings are subject to review and analysis by academics, consultants and investment attraction agencies prior to publication.

According to the survey, the global economic downturn and financial instability have made the latest multinational corporate investors more cautious about their medium term FDI ambitions. About half of the respondents suggested that the possibility of a global economic downturn represents a significant additional threat to their ongoing investment plans. Close to 40 per cent of respondents reported that the instability flowing from US economic conditions has had a significantly negative impact on their investment plans for the next three years.

Other elements of the latest World Investment Prospects Survey appear to confirm these sentiments. FDI plans have been revised downwards compared to last year's survey – only 21 per cent of companies anticipate a 'large' increase in their investment expenditures globally over the next three years, compared with 32 per cent in the survey of the year before. The proportion of those companies which only plan a 'moderate increase' has risen to 48 per cent from 38 per cent in the previous survey.

1 UNCTAD, 2008a, "World Investment Prospects Survey 2008-2010", United Nations, Geneva

While it is difficult to ascertain the full impact of global macroeconomic instability on international capital flows, one source recently estimated a reduction in annualised global FDI in the order of ten per cent for 2008 compared to the previous year.[2] In a further signal of a recent slowdown in foreign investment activity, UNCTAD reported a reduction in the number of greenfield investments globally of about two per cent during the first quarter of 2008 compared to the same period in 2007.[3] These preliminary results imply a more cautious attitude toward global investment by multinational corporations in recent months.

An important issue raised by a recent survey relates to concerns about more prescriptive FDI regulation. The UNCTAD World Investment Prospects Survey for 2008-10 shows that 48 per cent of responding multinational company executives are worried about the risk of negative changes in countries' investment regimes.[4] Other surveys report similar concerns about 'capital account protectionism', driven by, for example, rising hostility against direct investment by foreign interests (including SOEs) in local companies.

## *2.2 Australia's place in the international investment environment*

Australia has managed to attract extra foreign capital stock over the past 25 years – increasing from about $25 billion in 1980-81 to about $347 billion in 2006-07 (or from about 18 per cent of GDP to about 33 per cent).[5] However, the more uncertain global economic situation is likely to have a very real impact on Australia's economic growth through reduced foreign investment. Challenges and opportunities abound in the current environment.

The UN studies indicate that some contradictory trends are pressing on Australia's international investment performance. Survey data shows that representatives of multinational corporations appear less certain about investing in Australia (and other countries such as Japan, New Zealand and some original European Union countries).[6] In the latest UNCTAD survey of the foreign investment outlook, Australia has lost some ground compared to other countries such as Germany and Indonesia (Figure 1).

2 Herman, S., 24/09/2008, "US Financial Crisis Expected to Affect Foreign Investment" VOA News; and UNCTAD, 2008b, "World Investment Report: Transnational Corporations and the Infrastructure Challenge", United Nations, Geneva, pxvii

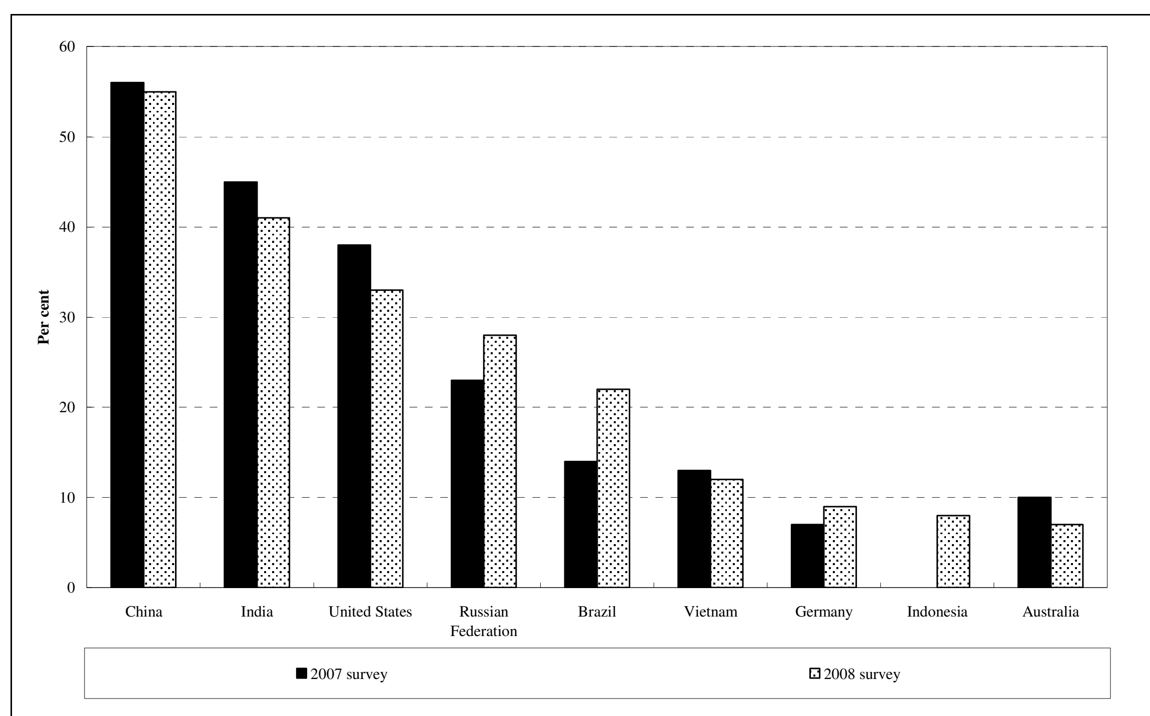
3 UNCTAD, 2008a, p8

4 UNCTAD, 2008a, p19

5 Reserve Bank of Australia, "Australian Economic Statistics 1949-50 to 1996-97"; and Australian Bureau of Statistics, "Balance of Payments and International Investment Position, Australia", cat. no. 5302.0

6 UNCTAD, 2008b

## *Figure 1: Most attractive countries for the location of foreign investment*




1. Based on percentage of responses to UNCTAD World Investment Prospects Survey
**Source:** UNCTAD, *World Investment Report: Transnational Corporations and the Infrastructure Challenge*. (Geneva: United Nations, 2008)

Although the survey report does not provide reasons behind weakening sentiment for Australia as a FDI destination, respondents broadly identify a range of risk factors to global investment going forward. These include a global economic downturn, financial instability, inflation risks, as well as unfavourable changes in FDI policy regimes. Some of these factors could be pertinent to Australia's situation.

That said, Australia remains in the top ten of most attractive countries in which to invest through to 2010, while the East, South and South-East Asian regions remain favourable FDI destinations. In addition, a high demand for natural resources (such as minerals) is expected to attract capital from foreign sources.[7]

How Australia reconciles these competing trends will be critical in attracting FDI. A case can be put forward that Australia can position itself as a global 'safe haven' for foreign investors seeking profitable destinations in which to invest.

Whereas domestic growth is expected to moderate somewhat, it appears that most of the problems directly associated with the financial system meltdown internationally have not substantially affected domestic financial institutions to date. Together with general political stability and a highly skilled workforce, these positive factors could put Australia in a position to potentially secure even more capital.

However, continuing flows of foreign capital cannot be taken for granted. As will be discussed below, the prospect for Australia transforming its FDI potential into reality will critically depend on its foreign investment policy regime.

7 UNCTAD, 2008b, p33

## 3.0 Australia's already restrictive investment regime

The success of countries to attract FDI partly depends on the barriers and restrictions imposed on investments. However, the true extent to which Australia has realised a liberal foreign investment regime has long been the subject of policy debate.[8]

Policymakers frequently claim that Australian FDI policy is relatively liberal by its nature. In a July 2008 speech to the Australia China Business Council, the Commonwealth Treasurer Wayne Swan said that 'Australia is an open, liberal nation that makes its living through trade with the rest of the world … It follows that we have an open and welcoming approach to foreign investment'.[9]

Complementing these espoused principles is the notion that Australian FDI policy does not discriminate between investors. Recently the Prime Minister, Kevin Rudd, said Australian foreign investment regulation is 'non-discriminatory'. We have had foreign investment from Japan and Korea and the US and Great Britain for decades on a large scale'.[10]

It is important to critically assess these statements, given that the uncertain world macroeconomic situation means that Australia will have to compete more aggressively against other nations for available international capital.

Foreign investment screening restrictions seems to drive Australia's high score against an Organisation for Economic Cooperation and Development (OECD) benchmark measure of regulatory restrictions on FDI, based on an earlier study by the Productivity Commission.[11]

The measure, referred to as the 'regulatory restrictiveness index', aims to capture the extent of discrimination against foreign investors compared to domestic investors in a given country. The restrictions covered by the restrictiveness index can be broadly classified into entry and post entry operational restrictions.

The indicators take into consideration the following potential restrictions:

- Equity restrictions: Discriminatory barriers to entry in the form of limitations on foreign ownership, typically in the form of limiting the share of companies' equity capital in a sector that non-residents are permitted to hold;
- Screening restrictions: Special screening procedures which only apply to foreign investors, such as prior approval of FDI and stipulations that investors must demonstrate the economic benefits of their project; and
- Operational restrictions: Post entry management and other operational restrictions imposed on the foreign investor, for example stipulations that nationals or residents must form a majority of the board of directors of a firm subject to foreign investor interest.

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8 Kasper, W., 1984, "Capital Xenophobia: Australia's Controls of Foreign Investment", Centre for Independent Studies, St Leonards, Australia; Drysdale, P. & Findlay, C. 09/2008, "Chinese Foreign Direct Investment in Australia: Policy Issues for the Resource Sector", Presentation to Australian National University Crawford School Public Seminar; ITS Global, 09/2008, "Foreign Direct Investment in Australia – the increasing cost of regulation", September; and Stoeckel, A., 07/2008, "Sovereign Wealth Funds: Friend or Foe?", Speech presented to Australia-China Business Council Forum

9 Swan, W., 2008a, "Australia, China and This Asian Century", Speech to the Australia-China Business Council Forum at http://www.treasurer.gov.au/DisplayDocs.aspx?doc=speeches/2008/021.htm&pageID=005&min=wms&Year=&DocType=1

10 Callick, R., 22/09/2008, "Open for business: PM tells Chinese", The Australian

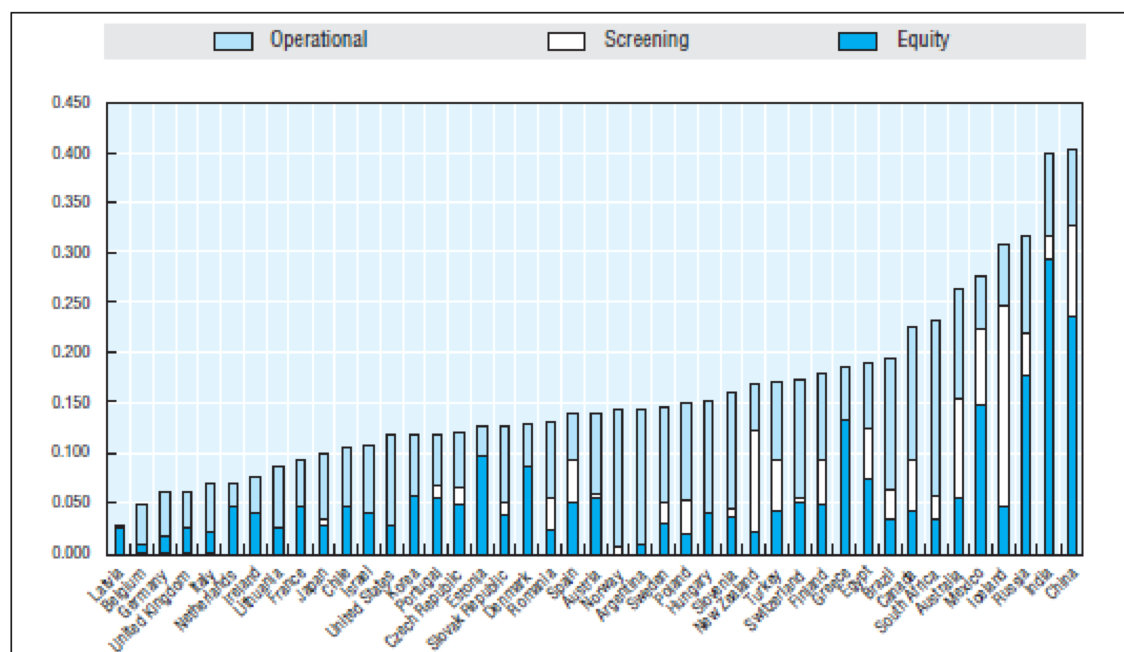
11 Hardin, A. & Holmes, L., 1997, "Services Trade and Foreign Direct Investment", Industry Commission, Canberra, Australia

These direct foreign investment restrictions can either be across-the-board, applying to all sectors, or sector specific. Weights are applied to these three elements of FDI restrictions when determining the final index results for OECD countries.

The OECD index measures FDI restrictiveness on a zero-to-one scale, with zero representing full openness and a score of one reflecting a prohibition of foreign investment. Restrictiveness is first calculated at the industry level (covering nine sectors), and then a weighted national average is obtained using FDI and trade weights.[12]

According to the latest FDI regulatory restrictiveness index results, Australia has the most restrictive foreign investment policy regime of all OECD countries except Iceland and Mexico (Figure 2).[13] The FIRB screening processes are pivotal to Australia's final index score – the abolition of the screening policy, with other country policies held constant, would reduce Australia's score, and place it toward the middle range of OECD countries. [14]

### *Figure 2: OECD FDI Regulatory Restrictiveness Index scores*




1. Aggregated index for nine sectors (business, telecommunications, construction, distribution, finance, tourism, transport, electricity and manufacturing). A higher value implies a more restrictive FDI policy.
**Source:** OECD 2007.

There are a number of caveats that imply that the OECD regulatory restrictiveness index results alone are insufficient to predict the attractiveness of specific countries to foreign investors, and should therefore be treated with caution.[15] However, in the absence of better alternatives, the OECD measure does lend at least some weight to the argument expressed in this paper that Australia's statutory FDI regulations are potentially quite restrictive in theory, if not in practice.

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12 OECD, 2007, "International Investment Perspectives: Freedom of Investment in a Changing World", Paris, France

13 OECD, 2007, p139 and Stoeckel, 2008, p11

14 It is notable that the OECD index shows that the United States, with the largest relative share of FDI flows in the world, similarly does not impose any screening policies on foreign investors. The extent to which Australia's FDI screening procedure detracts from its ability to attain foreign capital relative to non-screening countries (controlling for other factors such as economy size, resource endowments, institutional factors, and so on) is an issue subject to further research.

15 Novak, J., 2008, "Australia as a destination for foreign capital", AOIF Paper 1, p9

## 3.1 *More regulation, more politicisation, less investment*

Australia has a formal foreign investment policy under the *Foreign Acquisitions and Takeovers Act 1975* (the Act), and accompanying regulations. The Act establishes pre-screening processes for major investment applications, defined as any purchase by a foreign entity, and any associates, of more than 15 per cent of an Australian company, or by several foreign entities of more than 40 per cent in aggregate. Investors are obligated to notify government of their proposal, prior to commencement, if it exceeds a set of monetary thresholds including:

- acquisitions of substantial interests in an Australian business where the value of its gross assets, or the proposal values it, in excess of $100 million;
- proposals to establish new businesses involving a total investment of $10 million or more;
- takeovers of offshore companies whose Australian subsidiaries or gross assets exceed $200 million and represent less than 50 per cent of global assets.[16]

There are additional restrictions on sensitive industries such as airports, banking, media, residential real estate, telecommunications and transport (civil aviation and shipping).

Applications for major foreign investments in Australia are assessed by the Foreign Investment Review Board (FIRB). FIRB is an arm of the Commonwealth Treasury and final decisions of FIRB rest with the Commonwealth Treasurer. The legislation requires the FIRB to assess an application within 30 days (although this can be formally extended up to 90 days).

The government assesses large foreign investment projects in accordance with a 'national interest' test. Importantly, there is no definition of 'national interest' under the Act. In effect, 'national interest' is determined by the government of the day and is interpreted on a case-by-case basis.

However, determining 'national interest' is not without precedent. A government report on Australia's foreign investment regime states that 'the Government determines what is 'contrary to the national interest' by having regard to the widely held community concerns of Australians'.[17] Consequently, the Commonwealth can deny entry to any significant foreign investor 'in the national interest' without legal constraints or transparent explanation.[18]

In effect, it is claimed that under the Australian FDI regime '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'.[19]

As an alternative to blocking FDI entry, the Treasurer can reserve the right to impose conditions on a major foreign investment proposal in order for it to be approved. According to a recent study, about 30 per cent of all proposals approved, by value, by the FIRB have terms and conditions imposed on them. This seems to be an inordinately high percentage given the claims that Australia has an

16 FIRB, 2008, "Annual Report 2006-07", Commonwealth of Australia, Canberra, Australia

17 Commonwealth Treasury, Spring 1999, "Foreign Investment Policy in Australia – A Brief History and Recent Developments", Economic Roundup, Canberra, Australia

18 ITS Global, 2008, p29

19 ITS Global, 2008, p3

avowedly liberalised FDI regulatory regime, and belies the publicly stated 'general presumption … that [unamended] foreign investment proposals will generally serve the national interest'.[20]

In practice, some FDI applications are likely to be withdrawn before the screening process is completed. The FIRB does not publish details of either the applications that are subsequently resubmitted in a modified form, after having being withdrawn, or the investment that is permanently foregone as a consequence of withdrawal. However, a study by ITS Global estimates that the economic cost of withdrawn investment could be as high as $1.5 billion per annum.[21]

There could also be some commercially viable, internationally footloose investments that bypass Australia altogether in favour of countries without screening processes. It is very difficult, if not impossible, to estimate foregone investment as a consequence of the FDI screening policy regime. Nonetheless, it is likely there will be some investors who overlook Australia precisely for this reason.

Another consideration is the likelihood that screening processes by the regulator under the Australian FDI regime may be time-consuming and subject to considerable delays. As noted above, the FIRB is obligated under legislation to deliver a ruling within 30 days, with an option for a decision to be extended to 90 days.[22]

Apart from the potential cost of any delays to the investor, the screening period may also fuel speculation about the attitudes of the government towards FDI. For example, in recent months, there have been reports of the FIRB encouraging some investment bids in the Australian resources sector from Chinese SOEs to be temporarily shelved. The Wall Street Journal Asia recently reported that 'market watchers believe Labor has been acting to slow investment without publicly opposing Chinese investors, while it decides how to deal with the wave of Chinese government-backed deals'.[23]

The magnitude of foregone investment opportunities cannot be known with certainty. However, questions surrounding the political attitude towards certain types of investors, or the proposed sectoral destination of their investments, could deter a number of otherwise commercially viable foreign investments taking place in Australia altogether.

The Treasurer has stated his awareness of the need to provide procedural fairness to all applicants, and this means 'taking appropriate time to consider proposals'.[24] Nonetheless, there is a need to balance the screening process (as problematic as it is) against the potential cost delays, in a global capital market invariably governed by the practical concept of 'time is money'.

20 FIRB, 2008, p7

21 ITS Global, 2008, p21

22 In practice, applicants of complex FDI proposals are often encouraged by the FIRB to withdraw and resubmit their investment application if they wish to avoid inclusion in a publicly-released gazette of their proposal after the cut-off period

23 Pannett, R., July, 7 2008, "Canberra takes hard look at foreign investments", The Wall Street Journal Asia

24 Swan, 2008a

# 4.0 The risk of sovereign wealth funds?

Australian FDI policy has also come under greater scrutiny because of adverse political and community reactions to a growing number of investment applications from China. Concerns have been raised by the political elite and general community alike regarding the rising Chinese FDI in Australian mining. The Commonwealth Treasurer expressed the view in July 2008 that:

> *'Australian governments – now as in the past – are particularly attentive when the proposed investor in an Australian resource is also the buyer of that resource or linked with the buyer of that resource. … it follows that as the proposed participation by a consumer of the resource increases to the point of control over pricing and production, and especially when the resource in question is already developed and forms a major part of the total resource, or where the market disciplines applying to public companies are absent, I will look more carefully at whether the proposal is in Australia's national interest'.*[25]

The Western Australian Premier, Colin Barnett, in late September 2008 stated that 'Australia could be overwhelmed by the weight of Chinese investment. … I believe Australia as a whole needs to agree on the rules of the game with this Chinese demand. I think we do need to make sure we do keep it manageable, that we don't lose control of our own economic development, in other words'.[26]

According to a recent survey conducted by the Lowy Institute, these concerns appear to be keenly felt amongst the general Australian community.[27] About 78 per cent of respondents opposed major foreign investments by companies, banks or investment funds controlled by the Chinese government. In general, 90 per cent of those surveyed believed that the Commonwealth government has a responsibility to ensure that major Australian companies are kept in majority Australian control.

In response to concerns, in early 2008 the Federal Treasurer introduced an additional six policy guiding principles on investment by SOEs or controlled entities:

- An investor's operations are independent from the relevant foreign government.
- An investor is subject to and adheres to the law and observes common standards of business behaviour.
- An investment may hinder competition or lead to undue concentration or control in the industry or sectors concerned.
- An investment may impact on Australian Government revenue or other policies.
- An investment may impact on Australia's national security.
- 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.[28]

These guidelines state that 'proposed investments by foreign governments and their agencies (e.g. SOEs are assessed on the same basis as private sector proposals. National interest implications are determined on a case-by-case basis. However, the fact that these investors are owned or controlled by a foreign government raises additional factors that must also be examined'.[29]

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25 Swan, 2008a

26 Taylor, P., 30/09/2008, "Barnett warns on investment", The Australian

27 Hanson, F., 2008, "Australia and the World: Public Opinion and Foreign Policy", Lowy Institute for International Policy, Sydney, Australia

28 Swan, 2008b, "Government Improves Transparency of Foreign Investment Screening Process", Press Release at http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/009.htm&pageID=003&min=wms&Year=&DocType=0

29 Swan, 2008b



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This addition to the FDI policy regime raises further uncertainty about the conduct of foreign investment policy, in particular towards Chinese investment. It contradicts the repeated assertions of the government that Australia's FDI regime is non-discriminatory towards all comers, since China's investment proposals would invariably come under the class of investments subject to the additional six principles.

Furthermore, as nebulous as the current national interest test may be, it could be argued that 'the *a priori* identification of a class of investment proposals as deserving of special scrutiny introduces an element of pre-judgement into the foreign investment review process'.[30]. Another argument is that, to some extent, the six principles outlined in February 2008 may duplicate controls that already exist.[31]

## 4.1 Is the risk real?

The motivations supporting the extra hurdles for SOEs are questionable. Bryan Caplan argues that there are four systematically biased beliefs that inform economic opinion amongst laymen.[32] These biases are an anti-market bias, an anti-foreign bias, a make-work bias and a pessimistic bias. Economic concerns about SOEs combine two, if not three, of these biases. Many people express concern about the market for corporate control even before suspicion of foreigners comes into play.

The anti-foreign bias within Australia can be broken up further. In the first instance, Australia has had a long history of xenophobia. The White Australia Policy, for example, operated for several decades to restrict immigration from non-European sources. While that policy has now been abandoned, Australia nonetheless still suffers from capital xenophobia. It is not clear, however, that a xenophobic dislike of foreigners explains a distrust of SOEs. For example, at present there is substantial public concern about a Chinese SOE acquiring an Australian firm, whereas previously a Singaporean SOE acquired an Australian firm with little fuss. Clearly, there are additional factors at work beyond mere xenophobia.

Many Australians view selling Australian assets to foreigners as 'selling the farm'. This view seems to suggest that Australian entrepreneurship is a non-renewable resource and that it has already been used up. The notion that Australian entrepreneurs will continue to develop new business ideas that are valuable in the global market does not enter into this type of argument. This is consistent with Caplan's pessimism bias. Of course, this argument overlooks the fact that foreigners pay for the Australian assets that they purchase. A related idea could be that foreign buyers systematically underpay for the assets that they purchase. This could be related to a cultural cringe argument that suggests that Australians are overawed by foreign investors and will not charge full price for their assets.

This is an argument well worth examining in closer detail. It may well be the case that Australians do sell their assets to foreigners at reduced prices. To investigate this issue Harvey Kho invested takeovers on the Australian Stock Exchange between 1997 and 2002.[33] Over that period he investigated 298 transactions consisting of 199 purely domestic bids and 92 cross-border bids. He

30 Drysdale and Findlay, 2008, p27

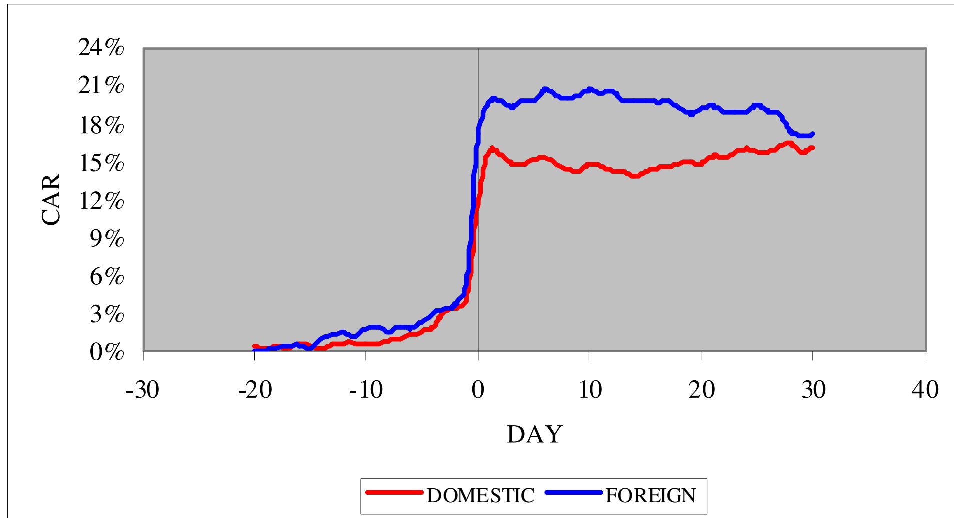
31 ITS Global, 2008, p2

32 Caplan, B., 2007, "The myth of the rational voter: Why democracies choose bad policies", Princeton University Press

33 Kho, H. K., 2004, "The impact of takeovers on shareholder wealth and factors affecting shareholder wealth: Evidence from Australia", Unpublished PhD thesis, RMIT University

then examined the stock market reaction to announcements of takeovers using a technique known as event study analysis. He is able to show the stock market reaction to domestic takeover announcements and compare those to foreign takeover announcements.

### *Figure 3: Stock market reaction to take over bids*




**Source:** Hock Khoon (Harvey) Kho, (2004), pg. 136

If foreigners underpay for their acquisitions we would expect the stock market reaction to be somewhat muted compared to Australian acquisitions. Yet we see, in figure three, that the stock market reaction to foreign acquisitions is greater than that for domestic acquisitions. This is not consistent with the view that foreigners acquire Australian assets on the cheap.

Arguments relating to economic concerns do not stand up to close scrutiny; however, there are a range of political concerns that cannot easily be countered by empirical analysis.

In the first instance some individuals may be concerned that foreign governments are investing in Australia. The argument here is that government is a particular institution that should be viewed with some trepidation. While this argument is more or less true, there are some aspects that are worth further investigation.

The first argument that should be debunked can be described as the Tom Clancy Debt of Honor argument. The 1994 novel, *Debt of Honor*, tells the story of a clandestine war between Japan and the US. In the story a Japanese consortium (secretly representing the Japanese government) acquires an American bank and uses that bank to crash the stock market thereby destroying US wealth. While it makes for great entertainment value, it is not at all clear that SOEs exist to establish beachheads in foreign economies and are a prelude to military conflict. In the first instance, the identity of SOEs, or their ultimate controlling shareholders, is not secret. Even if those countries that did operate SOEs were national security risks, most countries already have procedures and institutions in place to manage those risks.

Part of the problem may be that SOEs often purchase well-known iconic firms. This, however, is a well-known phenomenon in international investment. All foreign investors face an asymmetric information problem and when making investments in an economy and as such are more likely to invest is well-known firms. It s not surprising that SOEs follow the same pattern. The political risk here is not for the domestic economy, but rather for the foreign government. Ownership of a well-

known iconic firm provides a target for domestic protest against foreign governments. Whereas before protesters might target embassies, they now also have corporate targets when protesting against foreign governments.

A more serious political concern is the argument that SOEs represent a reversal of privatisation. Andrei Shleifer and Robert Vishny have argued that political interference in firm operations is likely to result in inefficiencies, misallocation of resources, and corruption.[34] SOEs have the potential to return ownership out of private hands back into inefficient public ownership; and worse, foreign government ownership. While this concern cannot be readily dismissed, nonetheless it is not immediately apparent that government portfolio investment represents the return to government managing firms in the hope of controlling the commanding heights of the economy.

The problematic issue associated with government ownership is that government can use its regulatory and police powers in addition to any market power it may enjoy. The ability to coerce individual consumers exists because the domestic government owns firms; it does not exist when foreign governments own firms. In other words, the economic and political abuses associated with government ownership are likely to occur when the domestic government owns firms and not when a foreign government owns firms. Foreign governments have no additional economic power in a domestic economy than does any other foreign investor.

It is for this reason that a clear distinction needs to be drawn between the activities of domestic state-owned enterprise and sovereign wealth funds (SWFs). State-owned enterprises normally exist to meet non-economic objectives of a government. Historically they have been associated with substantial levels of inefficiency and corruption. When making portfolio investments, however, government has tended to behave as does any other large investor. Their objective is to invest money and earn the highest possible return (for a given level of risk).

The final objection is that foreign governments are unaccountable to the domestic electorate. This is always true. This isn't just true of foreign government; it is also true of almost all foreign investors. The point remains, however, that SOEs have potential corporate governance problems. The important point here is to remember that the corporate governance standards that SOEs are accountable to are the domestic standards, not the foreign government standards. All firms that operate within the domestic economy are bound by local laws and so long as firms obey the law of the land, they are no different from any other firm. The problem with government is the exercise of sovereign power; foreign governments, however, do not exercise sovereign power in the domestic economy. Consequently SOEs should be considered the same as any other category of foreign investor.

The challenge for the Australian government is not the identity of large foreign investors, be they government or private, but ensuring that the standards of corporate governance for firms listed on the Australian Stock Exchange are rigorous and prevent large controlling shareholders from looting the firm's assets or expropriating firm value from minority shareholders. Given appropriate corporate governance standards, large controlling shareholders need not pose any investment threat or any other type of threat to Australia. With appropriate shareholder protection all investment would be in the national interest.

[34] Shleifer, A. and Vishny, R., 1994, "Politicians and firms", Quarterly Journal of Economics, v109, i4, pp995 – 1025. See generally, Shleifer, A. and Vishny, R., 1998, "The grabbing hand: Government pathologies and their cures", Harvard University Press

# 5.0 Liberalisation is the best reform

In an investment constrained global economy, it seems counter to Australia's national interest to restrict inward investment. There are clearly concerns about the role of SOEs as potential investors into the Australian economy, but the basis for these concerns appears largely unfounded. As outlined earlier the primary threat posed by SOEs comes from the beneficial arrangements they enjoy domestically from a close proximity to the State. But those benefits are not enjoyed extraterritorially. Australia still maintains the right to appropriately regulate where there may be a perceived risk from an external investor.

The current uncertainty about foreign investment by SOEs is affecting the potential gains for Australia. An executive of Shenhua Group, a Chinese coal mining SOE, was reported to have said in June 2008 that 'Chinese companies have got a kind of feeling that we are encountering unfair policies. We don't want any preferential policies, we just want fair and open competition'.[35] Others have perceived the guidelines to be part of a broader push by the Commonwealth to discourage investments by Chinese SOEs. For example, the Wall Street Journal Asia reported that 'market watchers believe Labor has been acting to slow investment without publicly opposing Chinese investors, while it decides how to deal with the wave of Chinese government-backed deals'.[36]

Instead of being afraid of SOEs, the Australian government should embrace the opportunity that SOEs provide in an investment-constrained environment. To do so the Commonwealth government should continue to liberalise its foreign investment policy. This will also ensure that political agents and their bureaucrats play a reduced role in determining what FDI projects should take place.

The Treasurer's FDI principles seem to be founded on a concern that SOEs are funded, and can be underwritten by, taxpayers and are beholden to the decisions of political masters. In comparison, private firms undertaking investment are accountable to their shareholders and are directly responsive to competitive market forces through the profit-and-loss mechanism.

However, there has been precious little evidence to suggest that SOE investors in other countries have not been motivated to pursue commercially prudent FDI decisions. Regarding the case of a SOE, Stoeckel observed that even 'if a fund pursues a non-commercial agenda, which then proved detrimental to the interests of its host, it would be running the risk that all future foreign investments it proposed would be rejected'.[37] A similar principle can apply in the case of an SOE intending to invest capital in Australia.

In addition, the value that the foreign investor places on the firm's assets, and any subsequent operations of an Australian firm with the injection of foreign SOE or SOE capital, will be the subject of continuous market testing in domestic and global economies.

Accepting the case that most FDI projects by SOEs are commercially motivated, there would seem to be little point in Australia setting up additional FDI policies to block any proposed foreign investment by these entities subject to the observance of domestic laws and business standards.[38]

All foreign investments, regardless of source, are subject to Commonwealth, State and local government laws. This should be sufficient to ensure that a foreign SOE investor will not create

35 Garnaut, J., 2008, "Master of the universe", The Diplomat, July-August at http://www.the-diplomat.com/article.aspx?aeid=7711

36 Pannett, 2008

37 Stoeckel, 2008, p13

38 ITS Global, 2008, p26

monopolistic industry conditions, evade taxes or abrogate corporate or other legal standards in Australia. The fact that these domestic policies exist effectively renders a number of the principles outlined by Treasurer Swan superfluous.

There are suggestions that the new guidelines are fuelling uncertainty amongst certain foreign investors, potentially harming Australia's capacity to attain more FDI inflow.

Ultimately, whether the board and shareholders of a privately owned Australian corporation wishes to entertain a proposal for acquisition of its assets by a foreign SOE should be a matter for the individual corporation, not of the Australian government. It is therefore an unnecessary addition to government bureaucracy that the FIRB should be accorded extra functions to test foreign SOE investment applications.

# 6.0 Conclusions

The economic uncertainties currently afflicting the world do not necessarily cast 'gloom and doom' for Australia. A window of opportunity for Australia to become a 'safe haven' for FDI in the Asia Pacific region is now open. And the growing enthusiasm by Chinese-backed SOEs partly demonstrates that potential.

However, many observers have been particularly concerned about the rise of government-backed entities interest in Australian assets. But their concerns appear to be rooted in false premises. The principle concern about SOEs is that they will use their investment for political, rather than economic interest. But the capacity for SOEs to do so is based on their capacity to leverage beneficial arrangements through laws and regulations as a result of their proximity to the State. But the benefits of proximity doesn't extend extraterritorially because domestic governments maintain the right to regulate business conduct and behaviour within their sovereign territory.

Rather than prohibiting SOEs, the Commonwealth government should liberalise Australia's investment regime and remove additional hurdles to SOEs investments in Australia. But in doing so, it should also ensure that the domestic legal and regulatory framework operates to inhibit coercion and market manipulation. In such an environment it is unlikely that SOEs will have any adverse consequences that may arise from the identity of their owners.

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