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Counting the cost of regulation

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AUSTRALIA'S OPEN INVESTMENT FUTURE

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EXECUTIVE SUMMARY

Since European settlement Australia has relied heavily on foreign investment, either by borrowing abroad (foreign debt) or by allowing greater foreign ownership of domestic assets (foreign equity). This has helped to generate faster economic growth and progressively higher living standards. As a result, Australia usually runs a current account deficit and the accumulated deficits represent the gap between domestic investment and domestic saving.

The increasing tendency for Australian firms to invest abroad has added another dimension to the contribution that foreign investment makes to Australia. Increasingly they are using investment abroad to expand beyond 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.

Foreign investment is regulated by the *Foreign Acquisitions and Takeovers Act 1975*. All foreign investment over specified monetary thresholds has to be screened and approved by the Government as being in the 'national interest', prior to its execution. The Government is able to decide cases as it sees fit. Some 30 per cent of approved investments by value have conditions imposed on them by the Government.

The emergence of a new group of global investors owned or controlled by governments from jurisdictions without appropriate standards of government or business conduct or which provide their investors with unfair advantages. While such cases raise legitimate concerns about the state of the global 'playing field', any discrimination against a class of investors strikes at the heart of the international trading system, on which Australia depends.

To address these issues, the Australian Government has published six principles for considering investment by entities, which are owned or controlled by foreign governments.

These principles are, however, 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 reduce investment in the Australian economy.

Even before it adopted the six principles, Australia had one of the most restrictive foreign investment regimes in the OECD, not to mention in comparison with the rest of the world. Of the 43 countries that are monitored by the OECD, only China, India, Russia, Iceland and Mexico have more a more restrictive foreign investment regime.

Australia's regime needlessly restricts incoming investment and Australians suffer as a consequence. ITS Global estimates that the economic cost to the Australian economy from the foreign investment foregone is at least $5.5 billion a year. The OECD has estimated that the removal of Australia's restrictions would increase its stock of inwards foreign investment by nearly 50 per cent over the long term.

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

INTRODUCTION

Since European settlement Australia has relied heavily on foreign investment to underpin its economic development. This partly reflects the country's extensive endowments of natural resources, such as pastoral land and minerals, as well as the capital intensive nature of the development path that the country embarked upon.[1]

Australians tap foreign savings by either borrowing abroad — short- or long-term foreign debt — or by letting foreigners to increase their ownership of Australian assets — foreign equity. Foreign direct investment (FDI) is one form of foreign ownership.[2] Portfolio investment is another. FDI involve either the acquisition of existing assets or the creation of new ones but only the latter increases the nation's capital stock. After allowing for that distinction, foreigners have been a relatively small source of funds for domestic investment. Since the early 1960s, inwards FDI flows have only been around 7 per cent of domestic gross fixed capital expenditure.[3]

By drawing on foreign savings Australians have been able to finance greater investment than their own savings would have allowed. FDI has also increased international competitiveness by exposing local management to international business standards and best practice. It has provided access to advanced technologies and business innovations through the establishment of new businesses and the modernisation of existing ones. All have helped to raise productivity and living standards.

Despite its considerable importance to Australia's economic development, Australian politicians have exhibited a pronounced ambivalence towards foreign investment. As a consequence public policy in Australia towards foreign investment has veered between classical liberalism and economic nationalism.

The zenith of the classical liberal approach to foreign investment in Australia occurred in the late 19th and early 20th Centuries. At that time Australians enjoyed a much higher standard of living than the citizens of the UK or the US.[4] Australian banking sector was mature and sophisticated.[5] There was no central bank and only minimal regulation of banking.

The retreat to economic nationalism began with the introduction of central banking in 1911 and the imposition of controls on foreign exchange transactions in 1931. Following the Second World War, the Commonwealth Government began to use its foreign exchange controls to regulate inwards foreign investment from time to time.

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1 NG Butlin, *Investment in Australian Economic Development 1861-1900* (Canberra: Department of Economic History, Research School of Social Sciences, Australian National University, 1976)

2 Officially FDI is any equity interest of 10 per cent or more in an enterprise.

3 The Treasury, 'Trends in Foreign Direct Investment Inflows', *Economic Roundup* (Canberra: Department of the Treasury, Spring 1997, pp. 19-25) cited at http://www.treasury.gov.au/documents/202/PDF/Article02.pdf on 13 August 2008

4 Ian W McLean, 'Australian Economic Growth in Historical Perspective', *Economic Record* 80:250 (September 2004, pp. 330-345)

5 SG Butlin, *Foundations of the Australian Monetary System 1788-1851* (Melbourne: Melbourne University Press, 1953)

In 1975 the Commonwealth formalised a policy explicitly based on economic nationalism. It wished to encourage foreign investment but '…on a basis that recognises the needs and aspirations of Australians'.[6] It involved complex tests of the net economic benefit of proposed investments, a preference for Australians as directors and/or employees of foreign-owned companies, and requirements for Australian equity participation in foreign-owned companies in the natural resource industries.

From the mid-1960s to the mid-1980s, the regulation of foreign investment was more restrictive than either previously or subsequently.[7] In combination with high trade barriers, these restrictions lead to a misallocation of domestic investment and a severe decline in capital productivity over this period, which has been estimated at around 30 per cent.[8]

Since the late 1980s the approach to economic policy has swung back towards classical liberalism with the near complete liberalisation of all trade barriers, the floating of the Australian dollar, financial deregulation, and improvements in business regulation and taxation. These reforms have been critical to the historically unprecedented rates of economic growth that Australia has enjoyed since the early 1990s. They have not, however, been accompanied by an equivalent liberalisation in foreign investment policy, which continues to impose significant costs on the Australian economy.

AUSTRALIA'S FOREIGN INVESTMENT REGIME

Australia's policy regime on foreign investment is given legal force by the *Foreign Acquisitions and Takeovers Act 1975* and the *Foreign Acquisitions and Takeovers Regulations 1989* made under that Act.[9]

The Act requires foreign investment proposals to be screened prior to their execution wherever they exceed the monetary thresholds specified in the *Regulations*. After screening proposals may be allowed to proceed unless they are judged as not being in the 'national interest'. The screening thresholds are as follows:

- acquisitions of a substantial interest in an Australian business with gross assets in excess of $100 million;
- proposals to establish new businesses involving a total investment of $10 million or morel;

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6 The Treasury, 'Foreign Investment Policy in Australia — A Brief History and Recent Developments', *Economic Roundup* (Canberra: Department of the Treasury, Spring, 1999, pp. 63-70) cited at http://www.treasury.gov.au/documents/195/pdf/round5.pdf on 13 August 2008

7 The Treasury 1999

8 Ted Evans, 'Economic Nationalism and Performance: Australia from the 1960s to the 1990s', *Ninth Colin Clark Memorial Lecture*, Address by Secretary to the Treasury (Canberra: Department of the Treasury, 4 June 1999) cited at http://www.treasury.gov.au/documents/93/PDF/speech.pdf on 13 August 2008

9 The description of Australia's foreign investment policy is from The Treasury, *Summary Of Australia's Foreign Investment Policy* (Canberra: Australian Government, 2008) cited at http://www.firb.gov.au/content/_downloads/General_Policy_Summary_April_2008.pdf on 13 August 2008

- 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 size.

There are additional restrictions in ‘sensitive’ industry sectors. They include banking, civil aviation, airports, shipping, the media, telecommunications, and residential real estate.

Due to the Australia-United States Free Trade Agreement (AUSFTA), the equivalent thresholds for US investors are now much higher:

- $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, a proposal by a US investor to establish a new business in Australia does not have to be notified to the Government, except when it is made by an entity in which a US government has a prescribed interest. They are, however, subject to all other policy requirements that are relevant to the case in question.

The screening process is conducted by the Foreign Investment Review Board (FIRB). The Treasurer is responsible for making the decisions on individual investment proposals. In cases where the proposal does not conform to the policy, the Government can block the proposal, or to order the sale of any property that was purchased contrary to its guidelines.

In February 2008, the Federal Treasurer announced that the following principles would apply to screening of investments by entities owned or controlled by foreign governments.

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 behaviour.

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

4. An investment may affect Australian Government revenue or other policies.

5. An investment may affect Australia's national security.

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

On 24 August 2008 the Federal Treasurer announced the result of the first review under these principles, which was to allow the Aluminium Corporation of China Limited (Chinalco) to acquire 11 per cent of the Rio Tinto Group.

ECONOMIC COSTS OF REGULATORY REGIME

The regulatory regime in the *Foreign Acquisitions and Takeovers Act* and its *Regulations* generates significant costs for the Australian economy. The regime reduces the funds available for investment in Australia and thereby foregoing increases in living standards.

- The screening process imposes significant transactions costs on prospective foreign investors. These costs restrict the funds available for investment.

- Approval of a foreign investment proposal rests on it being in the 'national interest'. The ambiguity of this concept and its application significantly increases the uncertainty faced by prospective foreign investors, regardless of how well the screening process has been streamlined. This also reduces the funds available for investment.

- The new principles for screening investment proposals by entities owned or controlled by foreign governments will simply add to the transaction costs, while duplicating existing regulatory requirements. They will not, however, resolve the key issue of how best to protect national security.

Each of these issues is elaborated below.

Regime restricts investment

Some argue that the current regulatory regime does not restrict foreign investment to any significant degree. This is generally rationalised by referring to the low rate of rejection of applications to the Foreign Investment Review Board (FIRB)

Each year, the Treasurer rejects around 100 of all applications to the FIRB and executes a small number of divestiture orders.[10] Since 2000-01, an average of 1.3 per cent of proposed investments by value has been rejected following the screening process, although rejections tend to be relatively infrequent.[11] Table 1 has the year-by-year details of the applications to the FIRB and the outcomes from the review process.

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

- A number of investment applications are never fully assessed by the FIRB but are withdrawn before the Board can complete the process.

- Some investments, which would be commercially sustainable in the eyes of the potential investors, are never put forward to the FIRB for a formal review.

The foreign investment foregone as a consequence of the review process is a clear cost of the regime. It is likely to have increased due to the increasing share of domestic savings being invested offshore. Loss of such investment is, however, inevitable given the transaction costs that prospective investors confront in participating in the process.

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10 Most of the rejections are in the real estate sector (FIRB 2008)

11 As the FIRB recently changed how it reports the outcomes of the review process, the data published prior to 30 June 2000 are not comparable with those published since (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 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 FA&T Act	5.0%	3.4%	3.8%	4.1%	3.7%	3.2%	2.8%	3.6%
Share of applications withdrawn from review	8.2%	7.9%	6.9%	6.3%	5.9%	6.5%	9.0%	7.3%
No. of applications decided by review process	3,347	4,523	4,747	4,511	4,415	5,223	6,196	4,709
Proposed investment for applications decided by FIRB ($ 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	69.0%	59.5%	62.4%	60.4%	50.5%	84.5%	89.7%	68.8%
Share of proposed investment conditionally approved	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.

Transaction costs are the resource costs involved in concluding any exchange, such as the purchase or sale of a good or service. They include the search and information costs in locating the other party, the bargaining costs in concluding the terms for a contract with them, the costs to police and enforce that contract, as well as any the costs of any taxes or regulatory compliance associated with the exchange.

Such costs are an inevitable part of the screening process. Decisions on foreign investment proposals are meant to be made within 30 days of their being submitted to the FIRB and the Act allows a further 10 days for the interested parties to be advised of the outcome. Moreover, the review period may be extended for up to 90 days. Applicants may also be allowed additional time to provide 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.[12]

The transaction costs created by the screening process include the following.

- Professional services fees — for example for legal, accounting, investment and operational advice — are involved in preparing an application of any consequence.
- There are opportunity costs associated with the time and effort of investors, their executives and their staff in preparing an application for and in participating in the review process.

12 FIRB 2008

- Prospective investors face highly uncertain outcomes from the review process.

Rational foreign investors have to assess the rate of return from prospective investment opportunities in Australia after making due allowance for the opportunity cost of the resources in question as well as the probability of their receiving approval on terms and conditions that would be acceptable to them. If the net rate of return is greater than what they can obtain elsewhere, they will proceed with the FIRB application. If it is less than the alternative, they will pass up the Australian opportunity. The opportunities foregone as a consequence may not be readily evident but they are real nonetheless.

The uncertainty in such assessments can have a powerfully negative effect on foreign investors' willingness to proceed with an application to the FIRB. This reflects uncertainty about what constitutes Australia's national interest as far as foreign investment is concerned — an issue which is taken up in the next section of this paper. 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 foreign 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 it impact on investment. Foreign investors will tend to modify how they structure their proposed investments so as to improve their chances of approval. They will progressively review their decision to apply 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.

The uncertainty for foreign investors in doing so is considerable. As Table 1 shows, some 30 per cent of approved foreign investments have had terms and conditions imposed on them by the Government. Some of these are likely to have been unacceptable to the relevant investors and, as a consequence, they did not proceed with the proposed investment.

All of this means there are likely to be losses of prospective foreign investment at every stage of the review process, compared to what would have happened in the absence of the regulatory regime. The loss of any foreign investment almost certainly means lower domestic investment, a smaller capital stock, lower productivity, and lower living standards. In other words, restrictions on foreign investment have a similar impact on the domestic economy as restrictions on foreign trade.

A key issue is how large are these economic losses for the Australian economy. The following evidence suggests that they are likely to be significant.

The policy regime imposes a delay on all inwards foreign investment that is subjected to review. In 2006-07, 90 per cent of investment proposals were decided within 30 days of their receipt by the FIRB, compared to 92 per cent in 2005-06 (FIRB 2008). The FIRB does not publish details of the average time taken 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.

Such delays represent a permanent and continuing 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 that the economic cost of the delay in making the investment is around $4 billion a year. This estimate is based on approved foreign investment totalling $156.4 billion in 2006-07 and an assumed average delay of three months for each approval when they are weighted by the value of the proposed investment. The Social Opportunity Cost of the capital services foregone by the delay is assumed to be 10 per cent per year in real terms.

This estimate does not, however, include any allowance for those foreign investment proposals that are either withdrawn from FIRB review. It also excludes those that are not put forward to the Board due to an expectation that they would not be approved or not approved on terms and conditions, which would be acceptable to the investors in question.

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 involved. Based on 2006-07 data, we estimate the economic cost of the withdrawn investment could be as high as $1.5 billion a year. This estimate assumes that the value of the investment in withdrawn applications is equivalent to that in approved ones, that withdrawn applications are never resubmitted, and that the Social Opportunity Cost of capital is 10 per cent per year.

Some 30 per cent of the investments that are approved by the Government have restrictions placed on them. These vary considerably but apparently relate to ensuring or preserving the Australian character of the business being established or acquired. Given the absence of information on the precise nature of the restrictions that have been applied in each case, it is difficult to estimate the economic benefits and costs.

An unknown number of investment opportunities are never even considered by the FIRB. These cases do not generate an application due to the assessment by the relevant foreign investors that the probability of success is too low and/or the time and effort involved in making an application to the FIRB is too high. The lack of hard information on such cases makes it near impossible to estimate the foreign investment suppressed by the regime.

The Organisation for Economic Co-operation and Development (OECD) has confirmed the restrictiveness of Australia's regime. The OECD Investment Committee has developed an index to measure the restrictiveness of national regimes for regulating inwards FDI.[13] The OECD Index covers nine industry sectors in 43 countries. The industry sectors 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. The countries in the Index are:

- the 29 OECD member countries;[14]

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

14 Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Mexico, the Netherlands, New

- the ten non-OECD signatories to the *OECD Declaration on International Investment and Multinational Enterprise*; [15] and
- China, India, Russia and South Africa.

The OECD Index measures deviations from 'national treatment' — i.e. the discrimination against foreign investors compared to domestic ones. Regulations that apply equally to foreign and domestic investors are not considered, except for state monopolies. The Index accounts for barriers to entry such as limitations on foreign ownership, special screening procedures, and post-entry management and other operational restrictions. The methodology used is a variant of that developed for a Productivity Commission study of FDI in APEC economies.[16]

Each of the restrictions in the OECD Index is weighted for its severity on a scale from zero — no restrictions on foreign investment — to one — a complete prohibition of foreign investment. The heaviest weights are reserved for foreign equity restrictions and the lightest for screening and approval processes. The somewhat arbitrary nature of these weights means that the OECD Index does not always measure restrictiveness accurately. In combination with other known explanatory factors, however, it has proved to be very useful in assessing foreign investment regimes.[17]

The latest results from the OECD indicate Australia has one of the most restrictive regimes inside or outside the Organisation. Only China, Russia, India and Iceland are more restrictive than Australia. Were Australia to remove its restrictions, its stock of inwards foreign investment is expected to rise by nearly 50 per cent over the longer term.[18]

Regime increases uncertainty for investors

Australia's foreign investment regime is based on the superficially appealing notion of the national interest. The concept, however, is open to numerous interpretations and there is no generally agreed definition of it in either common or academic usage.[19] It cannot be

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Zealand, Norway, Poland, Portugal, the Slovak Republic, South Korea, Spain, Sweden, Switzerland, Turkey, the UK, the US.

15 Argentina, Brazil, Chile, Egypt, Estonia, Israel, Latvia, Lithuania, Romania, and Slovenia

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

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

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

19 Wikipedia defines the national interest as 'a country's goals and ambitions whether economic, military, or cultural'. In the process it 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

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

Notwithstanding the importance of the concept to Australia’s foreign investment regime, the *Foreign Acquisitions and Takeovers Act* does not provide a definition of the ‘national interest’ but allows the Government to decide it on a case-by-case basis. The Act provides no guidance on how the concept is to be applied and does not constrain the Government in how restrictive or liberal it may be in doing so.

The FIRB has been equally silent on the issue. It does not publicly comment on how it applies the concept in assessing proposals and in framing its recommendations to the Government. It does not discuss these issues in its 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 sensitive information provided by applicants.[20]

In such an environment the only substantive constraint on the Government’s handling of foreign investment issues is democratic accountability thorough the Australian Parliament. This makes all foreign investment issues inherently political and policy tends to reflect the views of the median voter, regardless of how little 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 to address. There are several reasons for this.

- Political uncertainty is qualitatively different to other forms of uncertainty investors 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 uncertainty, political uncertainty is well outside the knowledge and experience of most investors. Their ignorance is exacerbated by the relative opacity of the political process.

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

- Finally, there is generally little scope for investors to insure against the adverse consequences of political uncertainty.[21]

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to justify interventionist or warlike policies.’ (Wikipedia, ‘National interest’, The Wikipedia Foundation Inc, cited at http://en.wikipedia.org/wiki/National_interest on 20 August 2008)

20 The FIRB had 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 in the Administrative Appeals Tribunal of the FIRB decision to refuse the information sought. The appeal was eventually settled out of court but the terms of settlement were undisclosed (FIRB 2008).

21 Most of the insurance against sovereign risk is underwritten by government in most 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.

Most investors exhibit a high degree of aversion to political uncertainty. For this reason, foreign investment regimes involving a high degree of uncertainty are much more restrictive of investment. While successive Australian Governments have liberalised aspects of the foreign investment regime, the continuing heavy reliance on 'the national interest' remains the least liberal component of the regime and is inconsistent with the direction of policy reform in other areas of economic policy.

Regime selectively restricts foreign government involvement

The principles announced by the Treasurer are inappropriate for assessing the implications of foreign government ownership or control in the cases Australia is most likely to confront. These are expected to involve Asian countries, such as China, which have a fundamentally different view of the respective roles of the public and private sectors in commercial life.

The principles are likely to increase the restrictiveness of Australia's foreign investment regime and to result in the Government turning down substantial amounts of foreign investments that would have benefited the country. The following canvasses the reasons for this conclusion by examining each principle in turn. In doing so its discussion focuses on prospective investments by Chinese State Owned Enterprises (SOE).

Investor independence

A strict requirement for investor independence would almost prohibit any economically significant merger or acquisition by a Chinese SOE.

The lack of commercial independence of Chinese SOEs reflects China's institutional development as it evolves from a centrally planned to a market economy. Property rights are weak, the Chinese judicial system is politicized; and executive and legislative transparency is poor. The State maintains tight control over the financial sector and directly or indirectly owns all the banks. Investment is tightly controlled and regulated.[22]

In such an environment there is little or no basis for expecting that a major investment decision in a foreign country by a Chinese SOE could be taken without at least the tacit approval of the Chinese Government. This is widely believed to have been the case even for the proposal by Chinalco to acquire what was a minor stake in the Rio Tinto Group.[23] Indeed were positions to be reversed and an Australian SOE to be completing a major

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

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

investment in China, it would be unthinkable for the Board of Directors to proceed without at least the informal blessing of the Australian Government.

In such circumstances, the real issue is not the commercial independence of the investing entity but the objectives of its owner in allowing it to make the investment in the first place. If those objectives are essentially commercial in nature, and are expected to remain so, there would seem to be little point in worrying about the formal independence of the SOE. The main policy concern for a recipient country should be to ensure the transparency of the decision-making processes of the investing Government.

Adherence to common legal & business standards

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).[24] By 2006 the role of the State in the economy had shrunk so dramatically that there were, at that time, only 1.8 million SOEs employing fewer than 76 million workers to produce only 35 per cent of non-farm GDP.[25]

The extensive SOE reforms China has implemented to date have been an unqualified success. China has deliberately avoided the 'shock therapy' of rapid privatisation, which had occurred in the former Soviet Union. Although the Chinese Government kept key sectors under State ownership, it formalised and clarified SOE objectives, streamlined the legislative regimes to regulate business and the agencies that administered them, broke up sectoral monopolies into multiple competing businesses, gave SOE management and staff strong incentives to improve financial performance, including thorough employee ownership, and allowed foreign investors to buy into its SOEs.[26]

The performance of Chinese SOEs has significantly improved but they are still not as efficient as their private sector counterparts. The efficiency gap between them is substantial and there is no evidence it has narrowed.[27] Moreover, transparency has not improved to anywhere near the same degree as efficiency. Most Chinese SOEs operate thorough opaque holding entities and it is generally impossible to determine the exact ownership structure of Chinese business corporations. This includes those that claim to be privately owned.[28]

For these reasons the strict application of this principle would probably prohibit an investment by any Chinese business entity, regardless of its formal ownership. If the Chinese Government's policy aims are essentially commercial and are expected to remain so, there would seem to be little point in prohibiting the proposed investment. The better

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

25 Wildau 2008

26 Wildau 2008

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

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

approach would be to give the entity in question the opportunity to demonstrate how well it observes the laws and business standards of the host country.

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 *Trade Practices Act,* which, among other things, prohibits any merger or acquisition that is likely to reduce competition, unless they can be shown to have some offsetting public benefit. This is regardless of who owns the Australian businesses or assets in the transaction or where those owners 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'. Given this, it is not clear why the FIRB should undertake a second, parallel assessment of the competitive implications as proposed by the Treasurer's 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 observe the requirements of the *Trade Practices Act*; its 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.

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. There is no sound argument for the Australian Government making any approval under the *Foreign Acquisitions and Takeovers Act* conditional upon an assessment of these issues.

Implications for national security

Sovereign governments have the right and the obligation to protect national security. Recent international arbitral decisions have confirmed such rights *vis-à-vis* foreign investors under customary international law.[29] Multilateral and bilateral International investment instruments — including those signed by Australia — allow a degree of freedom for governments to judge their national security requirements for themselves.[30]

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

All countries, however, have an interest in limiting the restrictions on foreign investment to those cases where their security and other essential interests are clearly at stake. Excessive impediments will impose significant costs on both countries, including the one responsible for imposing them, and could lead to retaliatory action by the others, which would simply exacerbate the economic losses for both parties.

OECD governments have agreed that sound policy is based on the principles of regulatory proportionality, predictability and accountability.[31] Any restrictions on foreign investment should be no more costly or no more discriminatory than is absolutely necessary and should not duplicate other regulation that could do the job better. While both foreign investors and governments should protect commercially sensitive information, any restrictions need to be as transparent as possible. Finally, comprehensive parliamentary oversight and/or judicial review are essential for accountability.

Implications for Australian business, the economy & the community

On the face of it, this category is 'catchall' to provide the Government with an excuse for refusing a investment without having to disclose its real reasons for doing so.

Every investment project can be expected to have a negative impact on certain groups in the community, regardless of its impact on the community as a whole. New investment bid resources away from some businesses and increase competition with others. 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 would have to be assessed before the Government approves it. At a practical level this is impossible. No person or organisation could possibly know the nature and the extent of every impact an investment might produce or could acquire that knowledge.

In any arms length transaction between a willing Australian seller and a willing foreigner buyer — regardless of who owns or controls that entity — 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 transactions should be allowed 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.

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

CONCLUSIONS

The OECD rates Australia's foreign investment regime as is the sixth most restrictive out of the 43 economies it monitors: only China, India, Russia, Iceland and Mexico are worse. We estimate the regime costs the Australian economy around $5.5 billion a year (0.6 percent of GDP). The OECD has estimated that the removal of these restrictions would increase Australia's stock of inwards foreign investment by nearly 50 per cent over the longer term

Reforms since the 1980s have opened the economy 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 decline to approve any significant foreign investment 'in the national interest'without constraint.

Concerns are rising about investments owned or controlled by foreign governments. When such investors lack appropriate standards of business conduct or enjoy unfair advantages, there are legitimate concerns about the state of the global playing field. On the other hand, discrimination against foreigner business strikes at the heart of the global trading system on which Australia depends for its prosperity.

The principles announced by the Australian Government to address this issue are likely to further restrict foreign investment, raising the costs to the Australian economy without getting to the nub of the issue. This is how to tap the foreign savings essential for Australia's economic development, while minimising the risks to its economy and its national security.

The economic risks are that such investors would create monopolies, evade taxes, or ignore business regulations in Australia. The legislative means to address such problems are well-established and non-discriminatory. All foreign government owned and controlled businesses are subject to all Commonwealth and State laws but there is no basis to expect more of them.

While Governments need to protect national security, a generally agreed approach has yet to emerge. Any restrictions on foreign investment should be no more costly or more discriminatory than is absolutely necessary, should not duplicate other regulations, and should be as transparent as possible with comprehensive parliamentary oversight and/judicial review.