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# Capital Xenophobia II

Stephen Kirchner

# Capital Xenophobia II: Foreign Direct Investment in Australia, Sovereign Wealth Funds, and the Rise of State Capitalism

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# Foreword

Stephen Kirchner's analysis of foreign direct investment is a timely reminder of how important free international capital flows are not only to the economic freedom and prosperity of Australians, but also to the creative adaptation of our political and economic institutions to changing circumstances.

It is now widely realised that unhindered international trade has been the engine of sustained economic growth. It is less often realised that the tremendous increase in the international flow of production factors has been another, and often more important, cause of global advances in prosperity and the elimination of poverty. Human welfare has been greatly enhanced by cross-border flows of labour and skills, capital, technology, and entrepreneurship. Indeed, the modern era of globalisation has been carried forward primarily by worldwide movements of bundles of capital, technical and organisational knowledge, and enterprise (in other words, direct foreign investment) to attractive locations.

The growing international mobility of production factors has given national powerbrokers—politicians, union, and community leaders—useful feedback about what attracts and repels productive capital and enterprise. In many places, it has induced political leaders to reform laws and regulations to favour job and wealth creation (microeconomic reforms). But it has also created resentments among powerbrokers, whose scope for ideological or self-seeking action has been curtailed. This explains the agitation against globalisation among collectivists and socialists.

These fundamental insights—that direct investment promotes prosperity, sets individuals free, and disciplines collectivists—were clear in the minds of a small group of leading Australian industrialists, academics, and commentators who were deeply concerned about this country's poor economic performance during the Menzies, Whitlam, and Fraser years. These problems also were clear to me, then a temporary academic visitor who was vexed by Australia's poor growth record and industrial cringe and who had seen with his own eyes how free trade and free capital flows had boosted prosperity and liberty, first in Western Europe and then in East Asia.

At a conference I helped convene in 1977, everyone agreed that the closed Australian economy and opportunistic regulations inflicted unnecessary speed limits on Australian growth and job creation.[1] This conference led to a study that argued for the liberalisation of foreign trade and investment, as well as macroeconomic stability, as necessary preconditions for realising the economic potential of this lucky country. This in turn spawned the Crossroads Group, which elaborated and propagated these insights.[2] They have been proven correct by the Hawke-Keating reforms and the long 'Howard prosperity.'

It became also clear to me during the 1980s that official mistrust of direct foreign investment—capital xenophobia—continued to be a problem for wealth and job creation. This was odd, because this harsh continent could not have been developed in the nineteenth century, by so few people, into one of the world's most affluent economies and decent democracies without the contributions of foreign direct investment. I was therefore grateful to the Centre for Independent Studies when it gave me the opportunity in 1984 to argue for the abolition of cumbersome bureaucratic controls of direct foreign investment in a monograph entitled *Capital Xenophobia*.[3]

Much has since been done to correct xenophobic political and administrative practices and to attract foreign investors, but the basic machinery of political control remains in place. The very existence of this machinery, as well as some narrow-minded political interventions, greatly diminish our chances to attract productive capital, knowledge, and enterprise at a time when other nations have rolled out the welcome mat. The current financial crisis and the end to Australia's sixteen-year boom make a critical review of these government-made growth obstacles not just important, but urgent.

I therefore commend Stephen Kirchner's timely analysis of Australia's foreign investment regime, and his ideas on how to improve this critical ingredient in our prospective stability, prosperity, and liberty, to everyone concerned about our future.

**Wolfgang Kasper**
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University of New South Wales

## Endnotes

1 Wolfgang Kasper and Thomas G. Parry, eds, *Growth, Trade and Structural Change in an Open Australian Economy* (Sydney: Centre for Applied Economic Research, 1978).

2 Wolfgang Kasper, Richard Blandy, John Freebairn, Douglas Hocking, and Robert O'Neill, *Australia at the Crossroads: Our Choices to the Year 2000* (Sydney: Harcourt Brace Jovanovich, 1980). On the Crossroads Group, see Paul Kelly, *The End of Certainty: Power, Politics, and Business in Australia* (Sydney: Allen and Unwin, 1992); and John Hyde, *Dry in Defence of Economic Freedom* (Melbourne: Institute of Public Affairs, 2002).

3 Wolfgang Kasper, *Capital Xenophobia: Australia's Controls of Foreign Investment* (Sydney: CIS, 1984).

# Capital Xenophobia II: Foreign Direct Investment in Australia, Sovereign Wealth Funds, and the Rise of State Capitalism

Stephen Kirchner

## Introduction

In 1984, the Centre for Independent Studies published Wolfgang Kasper's *Capital Xenophobia: Australia's Controls of Foreign Investment*. Kasper's Policy Monograph lamented Australia's abandonment, from the mid-1960s, of its traditional open-door policy to foreign direct investment. Kasper's work made an influential contribution to the debate over foreign investment at a time when Australia had just embarked upon a major liberalisation of its economy, which included a progressive liberalisation of controls over foreign investment. This trend has continued well into the 2000s, with the federal government recently removing statutory limits on foreign ownership of Australian media assets.

Despite this progressive liberalisation, the legislative framework governing foreign direct investment (FDI) in Australia remains largely unchanged from that put in place by the Whitlam government in the mid-1970s. The Australian government still limits foreign ownership in major firms and specific assets. In addition to these statutory restrictions, foreign direct investment in Australia is also subject to sweeping ministerial and bureaucratic discretion, creating considerable uncertainty for foreign investors. According to the OECD, despite two decades of liberalisation, Australia still maintains one of the world's most restrictive FDI regimes.

Recent trends in capital inflows suggest that this continuing capital xenophobia is crimping foreign direct investment in Australia. The FDI share of total foreign investment in Australia has declined steadily since 1980, and Australia has underperformed in attracting its share of global FDI flows. Australia is potentially losing the benefits that attach to FDI but not to other forms of foreign investment such as portfolio investment.

The rise of sovereign wealth funds (SWFs) and state-owned enterprises (SOEs) as intermediaries of cross-border capital flows has raised new concerns in relation to foreign direct investment. The recent controversy over investment by state-owned Chinese firms in the Australian mining industry echoes many of the traditional fears about foreign investment. In this context, the Rudd government's efforts to clarify Australian policy on FDI have created more confusion rather than certainty. One view is that this confusion reflects a failure to properly apply Australia's existing framework for regulating FDI.[1] This monograph argues instead that such confusion is an inevitable consequence of a regulatory regime for FDI built around bureaucratic and ministerial discretion rather than the rule of law.

**Continuing capital xenophopia is crimping foreign direct investment … Australia is potentially losing the benefits that attach to FDI.**

*Capital Xenophobia II* updates Kasper's 1984 monograph. It first reviews the benefits of FDI for the Australian economy. Then, it examines Australia's recent performance in attracting FDI inflows, before considering the nature and operation of Australia's regulatory regime for FDI. The implications of the rise of sovereign wealth funds and state-owned enterprises for foreign investment policy are also discussed, and the problems with Australia's FDI regulatory regime are illustrated with reference to recent foreign investment proposals in the Australian mining industry.

Finally, this monograph considers options for reform. It calls for the continued easing of statutory restrictions on foreign ownership in Australia, and advances two options for reforming the existing FDI review and approval process. The first option involves abolishing the review process, with FDI to be regulated in the same way as domestic business investment. The second option would retain the existing review process but improve its operation. In particular, this option would seek to remove ministerial discretion from the process. These proposed reforms aim

to better position Australia to capture the benefits from cross-border direct investment, including investment intermediated by stated-owned entities such as sovereign wealth funds.

## Foreign direct investment and the Australian economy

The Australian economy has long benefited from foreign investment in general, and foreign direct investment in particular. The Australian Bureau of Statistics defines FDI as 'investment undertaken by an entity resident in one economy in an enterprise resident in another economy with the objectives of obtaining or sustaining a lasting interest in the enterprise, and exercising a significant degree of influence in its management.'[2] An equity stake of 10% is internationally recognised as establishing such an interest. Foreign portfolio investment consists of investment in equity and other securities not classified as direct investment.

Investment opportunities in Australia have exceeded domestic saving throughout its history. The shortfall in domestic saving has been made up by foreign investors supplying Australia with the necessary capital. This has allowed Australia to enjoy higher levels of consumption and investment than would have been possible if it relied only on domestic saving. With an open capital account, Australia can access capital at a lower price (for instance, at lower interest rates) than would be possible if it relied exclusively on domestic saving for its investment needs. Foreign investment, including FDI, supplements rather than supplants domestic saving, leading to a larger capital stock and stronger economic growth than would otherwise be possible. Tony Makin conservatively estimates the gain in Australian real income from net capital inflows between 1995–96 and 2004–05 at $2,500 per person employed.[3]

While the benefits of free trade in goods and services are now widely recognised, the same principles apply in relation to free trade in capital. Globalisation has increasingly seen specialisation and the division of labour spill across national borders. This phenomenon is not limited to production and trade in goods and services. It extends to saving, investment, and financial intermediation as well. National borders are political rather than economic constructs, and patterns of comparative advantage cut across these political boundaries.

**Foreign investment, including FDI, supplements rather than supplants domestic saving, leading to a larger capital stock and stronger economic growth.**

Australia's current account deficit has averaged 3.6% of GDP since 1960. Instead of talking about Australia's current account deficit (which has negative connotations), we could instead reference its accounting equivalent, the capital account surplus. Both the current account deficit and the capital account surplus can be viewed as measures of the contribution foreign investment makes to capital accumulation in Australia. Far from being a sign of economic weakness, the current account deficit is a sign of economic strength. When Australians borrow abroad, the increase in foreign debt is offset by an addition to the stock of domestic assets. The increase in the domestic capital stock funded by foreign investment thus provides the basis for future economic growth and rising living standards.

Foreign direct investment is one component of the overall inflow of foreign capital into Australia. However, FDI is widely recognised as having benefits not shared by other forms of capital inflow. FDI is typically accompanied by the transfer of technology, improved management techniques, intellectual property rights and other forms of intangible capital, all of which may yield productivity gains and spillover benefits, in addition to the direct contribution made by FDI to the expansion of the domestic capital stock. Foreign direct investment can thus have even more profound implications for domestic economic welfare than cross-border trade in goods and services. As Makin notes, these benefits can be difficult to quantify, and imply that the real income gains from foreign investment cited earlier are likely to be underestimates.[4]

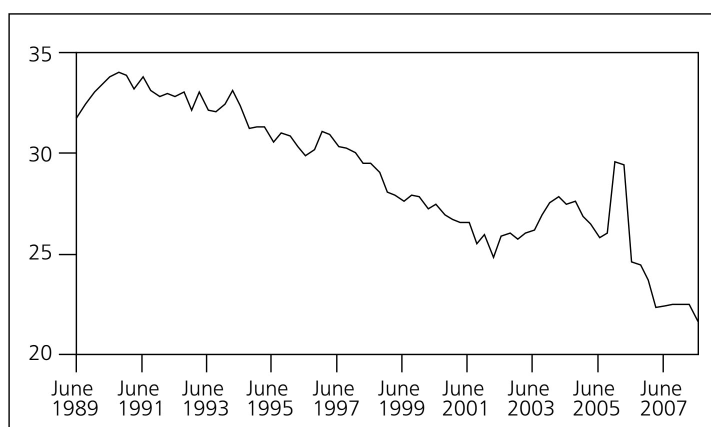
Foreign direct investment increases competition in the market for the ownership and control of equity and other forms of capital. Restrictions on foreign ownership may result in assets being held by those less able to maximise the returns on these assets, giving rise to a less efficient allocation of capital. It should be recognised that FDI restrictions also infringe on the ability of Australian residents to freely dispose of assets to potential foreign buyers and to realise potential gains that could fund further domestic investment spending.

Foreign direct investment is typically more long-term, and therefore more stable, than other forms of foreign investment, such as portfolio investment. Whereas portfolio investment in equity and debt securities can be very quickly reversed, direct investment gives foreign investors a more substantial stake in the relevant assets and the wider Australian economy, increasing their level of commitment. While the profits from foreign-owned businesses in Australia notionally accrue to their foreign owners, FDI is often accompanied by a substantial level of reinvestment of retained earnings in the host economy. Since the late 1980s, retained earnings have on average accounted for around 35% of foreign direct investment in Australia.

## Australia's declining share of global FDI flows

While FDI confers substantial economic benefits to recipient countries, there is evidence to suggest that Australia is increasingly underperforming in attracting FDI inflows. The FDI share of total foreign investment has been in steady decline, from around 50% in the early 1980s to around 23% more recently (see figure 1).[5]

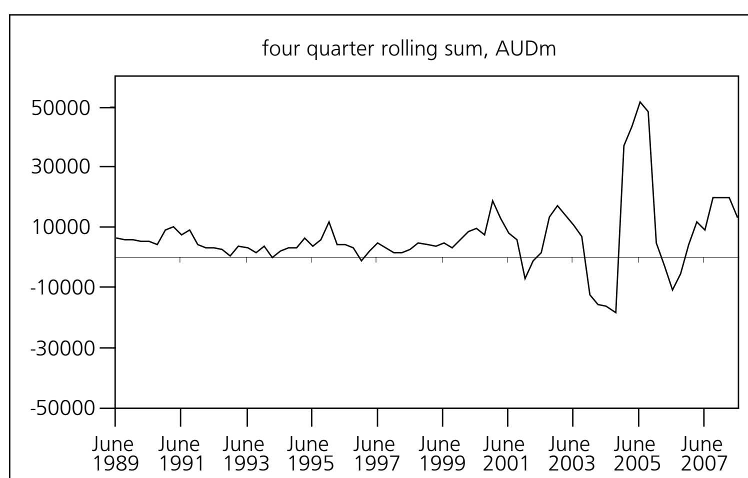
**Figure 1.** FDI share of total foreign investment in Australia (%)




**Source:** Australian Bureau of Statistics (ABS)[6]

Australian foreign direct investment abroad has been growing faster on average than foreign direct investment in Australia, such that Australia has in recent years seen periods in which it was a net exporter of direct investment capital (the negative values in figure 2). On current trends, Australia is set to become a permanent net exporter of direct investment capital.

**Figure 2.** Net direct investment in Australia




**Source:** Australian Bureau of Statistics (ABS)[7]

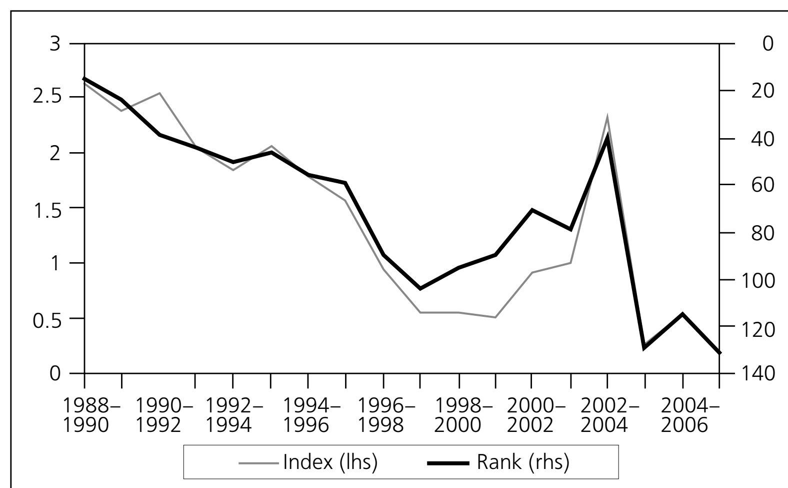
While this trend is partly symptomatic of the success of Australian business in expanding into overseas markets, it is nonetheless a curious position for a small and open economy like Australia's, which in recent decades has seen some of the strongest economic growth rates in the OECD, pointing to relatively high potential rates of return on investment by the standards of comparable developed countries. The investment share of Australian real GDP has reached record postwar highs in recent years, implying strong demand for investment capital. Despite record levels of investment spending, the Australian economy has also been increasingly capacity-constrained as a result of a near continuous economic expansion since the early 1990s.

Australia's growing role as an exporter of direct investment capital also highlights Australia's interest in actively promoting the liberalisation of cross-border capital flows. Just as trade barriers invite retaliation from other countries, domestic restrictions on foreign investment may encourage other countries to place restrictions on Australian investment abroad. Australia is increasingly vulnerable to capital xenophobia abroad. For example, Australia's Macquarie Bank has attracted hostile attention from the US Congress due to its prominent role in major infrastructure deals in the US.[8]

The failure of the OECD's Multilateral Agreement on Investment (MAI) in the late 1990s,[9] and the exclusion of investment from the Doha round of multilateral trade talks beginning in 2001, highlights the importance of unilateral and bilateral approaches to the further liberalisation of cross-border investment. Investment has become an increasingly important issue in bilateral free-trade negotiations. The most significant liberalisation of Australian FDI policy in recent years came via the Australia–United States Free Trade Agreement (AUSFTA) that commenced on 1 January 2005.

With FDI contributing a declining share of foreign investment in Australia, Australia has also been slipping in terms of its share of world FDI flows. The United Nations Conference on Trade and Development (UNCTAD) calculates an FDI performance index as part of its *World Investment Report* (*WIR*).[10] The index is based on the ratio of a country's share of global FDI inflows to its share of global GDP. On this measure, Australia has slipped from a value of around 2.6 in the late 1980s to as little as 0.192 more recently. The index has mostly been below 1 since the mid-1990s, indicating that Australia is underperforming in its share of global FDI flows.[11] Australia's FDI performance ranking in terms of 140 other countries has slipped from around 15th in the late 1980s to around 131st more recently (see figure 3).

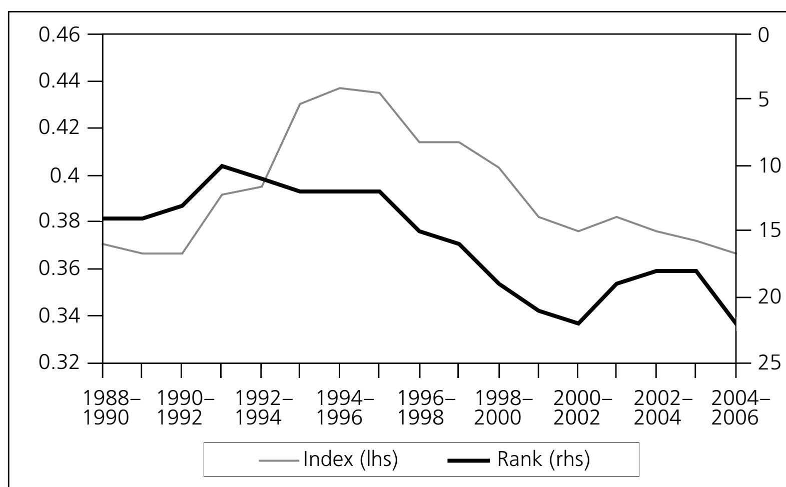
**Figure 3.** Australia's inward FDI performance index and rank




**Source:** UNCTAD (United Nations Conference on Trade and Development)[12]
**Note:** Horizontal axis shows rolling three-year windows.

The *WIR* also calculates a FDI potential index, based on factors that make a country attractive to FDI inflows. Australia's FDI potential index has been relatively stable in comparison, and consistently ranks Australia in the top twenty countries in terms of FDI potential (see figure 4). In the *WIR*'s FDI performance–potential matrix, Australia has been stuck in the 'high potential–low performance' quadrant.

**Figure 4.** Australia's inward FDI potential index and rank




**Source:** UNCTAD[13]
**Note:** Horizontal axis shows rolling three-year windows.

Australia has ranked between seventh and nineteenth in A. T. Kearney's Global FDI Confidence Index since 2003, suggesting that international sentiment towards Australia as a destination for FDI is somewhat volatile, although Australia's relative position may also reflect changes in sentiment towards other countries rather than Australia.[14]

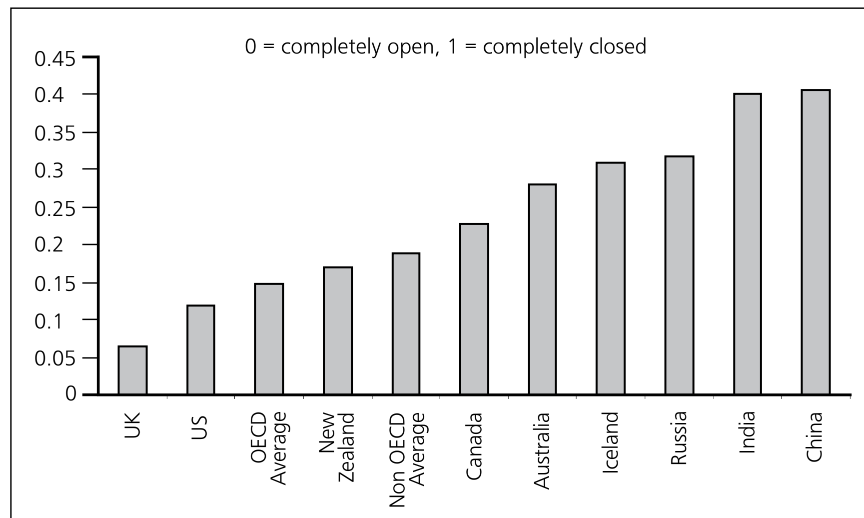
Australia is fortunate to have well-developed capital markets that can accommodate large inflows of foreign portfolio investment. In terms of Australia's overall external financing requirements, foreign portfolio investment can substitute for direct investment. Portfolio investment is a valuable source of capital inflow, but this may come at the expense of the economic benefits that uniquely attach to foreign direct investment. Many developing countries with underdeveloped capital markets do not have the same potential for portfolio investment, relying more heavily on direct investment. This might be thought to account for Australia's diminishing share of global FDI, as countries like China and India command an increasing share of these flows. However, comparable developed economies like Canada and New Zealand still rank higher than Australia in terms of their relative shares of global FDI.

**An obvious explanation for Australia's recent underperformance in terms of global FDI flows is the relatively restrictive regulatory regime it applies to FDI.**

## Australia's restrictive FDI regime

An obvious explanation for Australia's recent underperformance in terms of global FDI flows is the relatively restrictive regulatory regime it applies to FDI. The OECD compiles a measure of FDI restrictiveness for the purposes of making cross-national comparisons. On this measure, Australia has the fifth most restrictive FDI regime among twenty-nine OECD and thirteen non-OECD countries, behind only China, India, Russia, and Iceland. Australia's FDI regime is more restrictive than the average of both OECD and non-OECD countries (see figure 5).[15]

**Figure 5.** FDI regulatory restrictiveness of selected countries




**Source:** OECD[16]

As we shall see, it is no coincidence that Australia shares its high level of FDI restrictiveness with countries where the rule of law is weak, since the operation of Australia's FDI regulatory regime is also largely inconsistent with the rule of law. Manuel Agosin and Roberto Machado have also compiled cross-national comparisons of FDI restrictiveness. On a scale where zero is least open and five is most open, Australia scored a two in 1990 and 1996, and only a one in 2002. By way of comparison, for the same years, Canada scored all threes, while New Zealand scored three, four, and two respectively.[17]

**Australia shares its high level of FDI restrictiveness with countries where the rule of law is weak.**

Restrictions on foreign investment, including foreign direct investment, fall into two main categories. There are statutory restrictions on foreign ownership of Australian assets, including foreign ownership caps that limit foreign participation in Australian equity and other forms of capital. There are also ad hoc restrictions that result from the exercise of ministerial and bureaucratic discretion in relation to specific foreign investment proposals. These ad hoc restrictions can include outright rejection of specific investment proposals not otherwise banned by statute, or approval subject to government-imposed conditionality. Conditional approval can take a variety of forms, from ad hoc foreign ownership limits to specific undertakings in relation to operational issues, corporate governance, and other aspects of the proposed investment.

According to the Australian Treasury, the 'government's approach to foreign investment policy is to encourage foreign investment consistent with community interests.'[18] Australia's FDI regime is governed by the *Foreign Acquisitions and Takeovers Act 1975* (*FATA*) and the *Foreign Acquisitions and Takeovers Regulations Act 1989*. In conjunction with other legislation, these acts determine foreign ownership limits in relation to various firms, as well as specific assets. For example, total foreign ownership of Qantas cannot exceed 49%, with individual foreign stakes limited to 25%. Foreign ownership of Telstra is restricted to 35% of its privatised equity, with individual stakes by foreigners limited to 5%. Australian airports, banks, and shipping are also subject to foreign ownership restrictions. The Howard government proposed a 35% foreign ownership limit on Snowy Hydro, with individual foreign stakes limited to 15%, as part of its proposed privatisation.[19] The foreign ownership caps were designed to mollify the opponents of privatisation, but did not stop the privatisation plan collapsing under the weight of nationalist sentiment. If anything, the proposed ownership limits served to validate anti-foreign and anti-privatisation sentiment. The previous Labor government had imposed significant conditions on the 1995 sale to foreign interests of the food operations of Pacific Dunlop.[20]

Foreigners are generally prohibited from buying established urban real estate, being limited to the acquisition of new land for development or newly constructed developments, although no more than 50% of new development projects may be sold to foreigners. This policy is aimed at ensuring that FDI in real estate 'increases the supply of dwellings and is not speculative in nature.'[21] However, this policy falsely assumes that foreign direct investment in developed urban land displaces rather than augments investment by Australian residents. Expanding the scope for foreign investment in urban land would likely increase rather than limit overall supply, by increasing the total amount of capital available to be invested.

In addition to these specific statutory restrictions on foreign ownership, *FATA* gives the Treasurer discretion to 'block those proposals subject to *FATA* which would result in a foreign person acquiring control of an Australia corporation or business or an interest in real estate where this is determined to be contrary to the national interest.'[22] The 'national interest' is left undefined. According to Treasury, 'the government determines what "is contrary to the national interest" by having regard to the widely held community concerns of Australians.'[23] Since the Treasurer can effectively reject foreign investment proposals on the basis of an open-ended definition of the national interest, the regulatory regime for foreign direct investment is necessarily arbitrary in its operation and inconsistent with the rule of law. There is little transparency surrounding these arrangements and they are not subject to administrative or judicial review.

In administering the act, the Treasurer receives non-binding advice from the Foreign Investment Review Board (FIRB), a non-statutory body supported by the Foreign Investment and Trade Policy Division of Treasury. In considering FDI proposals, the FIRB takes account of general government policy and 'a proposal that does not meet the requirements set out in the policy would be regarded as being prima facie, contrary to the national interest and hence subject to rejection.'[24] Decision-making authority is delegated to the executive member of the FIRB, with over 90% of proposals decided under this delegation, with only larger or more policy-sensitive proposals involving the board and the Treasurer directly.

Despite having one of the world's most restrictive FDI regimes, Australia's FDI policies have been progressively liberalised in recent decades.[25] The UNCTAD database counts twenty-five policy changes in Australia between 1992 and 1996 judged 'more favourable' to FDI, compared to one change deemed to be 'less favourable.'[26] There have been further liberalisation measures since then. For example, the regulatory regime for foreign investment in Australian media assets was for many years used as part of broader government policies to regulate ownership of equity capital in the sector, usually at the behest of producer interests. These restrictions were largely removed from 4 April 2007, although FDI in the sector is still subject to the review process that applies to FDI more generally.

**Despite having one of the world's most restrictive FDI regimes, Australia's policies have been progressively liberalised in recent decades.**

On 17 February 2008, the Treasurer announced a set of Principles Guiding Consideration of Foreign Government Related Investment in Australia. The principles were a response to growing interest in Australian assets on the part of state-owned firms, most notably from China. Peter Drysdale and Christopher Findlay argue that some of the principles represent a 'new development in policy.'[27] However, as the Treasurer himself readily conceded, 'these guidelines were those used by the previous government; they are what we use too. They are not new and they are blind to the source of country of any investment.'[28] Australia regulates investment by stated-owned entities in the same way as other forms of foreign investment, although direct investment proposals by foreign government-related entities are subject to review irrespective of size. The principles state that investment by foreign government-related entities will be considered based on the following considerations:

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 impact on Australian government revenue or other policies;
5. An investment may impact Australia's national security; and
6. An investment may impact on the operations and directions of an Australian business, as well as its contributions to the Australian economy and broader community.

As Greg Golding and Rachael Bassil note, 'no guidance has been given by the government as to how their consideration of the national interest would be impacted by each of these factors and the extent to which each factor is or is not satisfied or to what level the government will need to be satisfied of each factor.'[29] ITS Global has also highlighted problems with the application of these principles,[30] which were intended as a codification of existing practice, but serve only to underscore the sweeping discretion the Treasurer enjoys to reject foreign direct investment proposals on a wide range of largely open-ended criteria. The principles if anything expand rather than circumscribe the scope of that discretion. The Rudd government's attempt to clarify Australia's FDI regime has merely reaffirmed the refusal of successive of Australian governments to be bound by the rule of law in the regulation of foreign direct investment. As we shall see, the Rudd government's attempt to codify its approach to FDI has in practice created more confusion than certainty.

## The cost of Australia's FDI regime

The ownership and control of the stock of equity and other capital in Australia would likely be very different in the absence of statutory and other restrictions on foreign ownership (if there were no interest in changing the ownership of these assets, there would be no need for the restrictions). When assets change hands as part of an FDI transaction, there is a general presumption that the buyer expects to extract more value from the asset than the seller (whether this expectation is actually realised is another matter).

**The Rudd government's attempt to codify its approach to FDI has in practice created more confusion than certainty.**

Outright statutory restrictions on foreign ownership, the rejection of specific proposals for foreign direct investment on 'national interest' grounds, and even the conditional approval of FDI are likely to lead to less efficient ownership of the domestic capital stock than if market-based transactions were allowed to proceed unhindered. Just as the benefits of FDI go beyond the net addition to the capital stock, the costs of restricting FDI are likely to be considerably more than the value of the investment proposals explicitly rejected under Australia's regulatory framework for FDI. The declining FDI share of total foreign investment in Australia may reflect substitution of portfolio investment for FDI driven by foreign ownership restrictions.

According to the FIRB, the annual value of FDI proposals subject to outright rejection since 2001–02 has not exceeded $100 million, and has often been less than $50 million. In 2000–01, $9.7 billion was rejected, with Shell's attempted acquisition of Woodside Petroleum all but fully accounting for this total (see discussion below). By total value, around 68% of proposals decided by the FIRB have been approved unconditionally on average since 2001–02, while 31% have been approved conditionally. Between 2001–02 and 2006–07, the number of FDI proposals subject to outright rejection has been less than 2% of the total decided by the FIRB. However, the number of proposals subject to some form of conditional approval has been around 75% of all cases decided.[31]

These data do not show potential investments that are never submitted for approval due to statutory or other restrictions on foreign ownership, or because the potential foreign investor expects the application may be rejected as part of the review process. Some applications are never submitted as a result of prior consultation between the potential investor and the FIRB. They also do not directly capture FDI lost as a result of conditional approval that limits the size or scope of investment proposals. Given the discretionary nature of the regulatory regime for FDI, and the often conditional nature of FIRB approval, foreign investors are subject to considerable uncertainty when contemplating investment in Australia. This has a chilling effect on foreign direct investment

that is not captured in the FIRB data and may even contribute to higher sovereign risk premiums for Australian assets, raising Australia's cost of capital in global markets. The FIRB data are not directly comparable with the previously cited ABS data on FDI, which measures the actual value of FDI, as opposed to prospective FDI transactions requiring FIRB approval, and which applies a lower threshold for deeming when an equity stake qualifies as FDI.

ITS Global estimates the direct costs flowing from the administration of Australia's FDI regime at $5.5 billion annually.[32] The cost of delays in the approval process is put at $4 billion, while the cost of withdrawn applications is put at $1.5 billion. However, these direct costs do not capture the full welfare costs of Australia's restrictive FDI regime. The OECD has estimated that Australia could increase its stock of inward FDI by around 45% by lowering FDI restrictions to the level of the UK, the OECD's least restrictive FDI regime.[33]

## Global trends in FDI, sovereign wealth funds, and the rise of state capitalism

**Growth in FDI has been driven by policy liberalisation and has yielded significant economic benefits.**

Globalisation has been driven by increased cross-border capital flows, as the growing international division of labour in relation to saving and investment spills across national borders. FDI has been a significant component of these cross-border capital flows. Since 1980, the global stock of FDI has increased twentyfold, compared to a fourfold increase in nominal GDP and a sixfold increase in bilateral trade flows.[34] Much of this growth in FDI has been driven by policy liberalisation and has yielded significant economic benefits. The UNCTAD database notes 2,218 policy changes deemed to be 'more favourable' to FDI between 1992 and 1996 on the part of member states. Only 224 changes were deemed to be 'less favourable.'[35]

More recently, however, increased politicisation and a growing protectionist trend has been observed globally in relation to foreign direct investment.[36] This has been most notable in relation to high-profile transactions involving politically-sensitive industry sectors and assets, particularly those seen to have national security implications or otherwise deemed to be 'strategic' in nature. These transactions are coming under increased public and political scrutiny, especially since the events of 11 September 2001.

This growing protectionist trend partly reflects a shift towards new sources of global saving in developing economies, where the state plays a large role in financial intermediation. Ben Bernanke has highlighted growing excess saving on the part of some emerging market economies as a significant trend in global capital markets.[37] His 'global saving glut' hypothesis offers an explanation for growing current account imbalances between developed 'deficit' economies such as the US and Australia and developing 'surplus' economies such as China. This excess saving in turn reflects domestic financial repression in emerging market economies such as China, which have closed capital accounts and managed exchange rate regimes and where the state sector plays a dominant role in financial intermediation. The global commodity price boom has also seen increased saving on the part of commodity exporters, particularly oil producers. Commodity export revenues and royalties often accrue directly to state-owned entities.

Understanding the role of saving and investment in driving global imbalances results in a very different interpretation of trends in global capital markets compared to more popular interpretations, which attribute imbalances to excessive consumption in developed economies. The magnitude of excess saving on the part of some developing countries is such that only developed country financial markets are deep and liquid enough to accommodate that saving. Developing-country holdings of developed-country financial assets, such as Chinese holdings of US Treasuries, are often interpreted as a form of financial dependence, but this dependence actually runs in both directions, as Reserve Bank of Australia (RBA) deputy governor Ric Battellino has explained:

> The popular perception is that, somehow or other, the US is out there spending a lot of money and has to go around the world borrowing to fund that expenditure. I am not sure that is the correct interpretation of what is happening. I think that what is really

> happening is that the investors of the world want to invest in the US financial markets …
> I am not sure that there is a huge problem of US indebtedness. I think this is really a sign that world investors actually very much value the characteristics of the US financial markets … People who have excess savings want to put a lot of their money in the US.[38]

The recent credit crisis has done little to diminish the appeal of US assets to SWFs. Indeed, SWFs have if anything seen the credit crisis as an opportunity to increase exposure to US assets, particularly in the financial sector. The fundamental cause of current account imbalances and the capital flows that finance them is thus the desire of foreigners to invest in countries like the United States and Australia. US and Australian consumption and investment spending merely accommodate this excess saving on the part of developing countries.

The prominent role of state-owned entities in the intermediation of excess saving is responsible for the growing importance of so-called sovereign wealth funds in global capital markets. Depending on the definition used, there are around fifty-four SWFs in thirty-seven countries, with total assets of around US$5.3 trillion.[39] By contrast, the size of global capital markets, including world stock market capitalisation, private and public debt securities, and commercial bank assets, has been estimated at US$200 trillion.[40] However, there is a distinction to be drawn between the role of SWFs as financial intermediaries and the ultimate sources of excess saving. As Edwin Truman notes, it is a myth to say that SWFs are net providers of capital to western financial markets. Instead, they merely recycle global financial flows that would for the most part exist even in their absence.[41] It is thus not so much the financial flows that are problematic, but the role of SWFs as intermediaries of those flows.

SWFs take a variety of forms and have widely varying objectives. SWFs can be broadly divided into pension and non-pension funds. Pension funds administer pools of saving in support of government pension policies and are mainly concerned with tax and expenditure smoothing and inter-temporal wealth and income redistribution. Pension funds have assumed increased prominence as government policies anticipate the fiscal implications of aging populations, with the pension funds aimed at offsetting future growth in liabilities on the government's balance sheet. Australia's Future Fund falls into this category.

**The prominent role of state-owned entities in the intermediation of excess saving is responsible for the growing importance of so-called sovereign wealth funds in global capital markets.**

Commodity stabilisation funds are often used by commodity exporters to smooth commodity revenue flows and as macroeconomic stabilisation tools. These funds have assumed increased prominence due to the global commodity price boom since 2002, most notably on the part of oil-producing countries. Commodity funds are thought to account for as much as two-thirds of assets held by SWFs.[42] Commodity funds are also distinct from pension and other SWFs in that their assets are not matched by corresponding liabilities on the government's balance sheet.

Some SWFs administer official-sector foreign exchange and other reserve assets associated with managed exchange rate regimes, and can be viewed as extensions of the traditional portfolio management function undertaken by central banks, for example, China's State Administration of Foreign Exchange (SAFE). The accumulation of foreign currency reserves as a result of intervention in foreign exchange markets is typically funded by issuing domestic debt, which serves to soak up the addition to the domestic money supply. The accumulation of foreign exchange reserves therefore sees the accumulation of offsetting liabilities, although there may be some real wealth accumulation flowing from the valuation of foreign reserves and income earned on foreign assets.[43]

SWFs for the most part seek to maximise returns on the assets they manage on behalf of the state and often employ private external fund managers for investment decision-making. For the most part, they engage in portfolio rather than direct investment (as where China's SAFE acquired 0.3% stakes in the Australian banks Commonwealth, ANZ, and NAB). Most of their investment is in domestic or emerging- rather than developed-country markets, although there is a growing trend

toward cross-border investment in developed countries as domestic investment opportunities are exhausted.[44] In addition to SWFs, cross-border investments by state-owned enterprises (SOEs) raise similar issues. SOEs are more likely to engage in direct investment transactions than are SWFs.

Government ownership raises concerns about whether SWFs and SOEs might also pursue other, non-economic objectives on behalf of their state sponsors. But the variety of SWFs and state-owned firms makes it difficult to generalise about these issues. On some definitions, Australia operates three SWFs: the Future Fund, the Queensland Investment Corporation, and the Victorian Funds Management Corporation. For better or worse, Australia is in the SWF business, so any concerns Australia might raise about SWFs could also be raised by foreign governments in relation to Australia's SWFs. Countries like Singapore have a corporate sector that is largely, even if only indirectly, government-owned, while many European firms are also government-owned, but these stated-owned firms may not have much in common with state-owned firms in China. State ownership in itself may not be a useful guide to how cross-border investment by these entities should be regulated.

**Foreign-owned businesses are subject to the same laws as their domestically-owned counterparts and so cannot engage in behaviour that is not also open to other firms.**

The rise of state capitalism has seen state-owned firms and SWFs assume a growing role in cross-border capital flows in general and FDI in particular. It is possible to take a benign view of global imbalances and the associated capital flows without necessarily taking a benign view of the role of sovereign wealth funds as intermediaries of those flows. Truman argues that 'Large cross-border holdings in official hands are at sharp variance with today's general conception of a market-based global economy and financial system in which decision making is largely in the hands of numerous private agents pursuing commercial objectives.'[45] Dan Ikenson suggests that 'The proliferation of SWFs is not a threat to the United States, but an affront to citizens in countries where large amounts of wealth and too many economic decisions are controlled by the state.'[46] To the extent that SWFs are the result of state intervention in domestic and global capital markets and pursue non-economic objectives, they may distort the global allocation of capital without necessarily increasing the overall supply of capital. SWFs might also distort financial market prices to the extent that they pursue active rather than passive investment strategies. However, SWFs may be more risk-averse than private investors, with longer investment horizons, so it is not clear that distortions from the presence of SWFs in capital markets lean toward more or less volatility. Given the diversity of SWFs, it is not possible to generalise about their impact on financial markets.

It is widely believed that foreign official-sector purchases of US Treasuries have lowered US interest rates, although empirical estimates of the effect range widely and some are statistically indistinguishable from zero.[47] It has been suggested that SWF diversification out of US dollar–denominated assets might put upward pressure on US interest rates. However, SWFs still hold less than 2% of the global stock of financial assets, and overall official-sector flows, including transactions by SWFs, are still very small in relation to total market turnover in those assets. Alan Greenspan has noted that because of the depth and liquidity of US dollar–denominated asset markets, 'large accumulations or liquidations of US Treasuries can be made with only modest effects on interest rates. The same holds true for exchange rates.'[48] Greenspan cites the most obvious example of the irrelevance of official reserve asset transactions when he notes that 'Japanese monetary authorities, after having accumulated nearly $40 billion a month of foreign exchange, predominantly in US Treasuries, between the summer of 2003 and early 2004, abruptly ended that practice in March 2004. Yet it is difficult to find significant traces of that abrupt change in either the prices of the US Treasury ten-year note or the dollar–yen exchange rate. Earlier, Japanese authorities purchased $20 billion of US Treasuries in one day, with little result.'[49]

SWFs have assumed increasing prominence in global equity markets, accounting for between 3% and 4% of global market capitalisation.[50] SWFs also account for a growing share of global merger and acquisition activity, although still only a small percentage of overall transactions. For a net capital importing country like Australia, being open to the supply of foreign capital is a more fundamental consideration than the nature of the intermediaries through which it is supplied. In

terms of the national efficiency case for free trade (in this case, free trade in capital), SWFs are likely to be less of a concern than from the perspective of the cosmopolitan case for free trade, which would decry both domestic and foreign distortions to capital markets. Apart from setting a good example, there is not much the Australian government can do about the policies of foreign governments. The Australian government can, however, facilitate growth in the domestic capital stock by being open to foreign investment, including that intermediated by SWFs and SOEs.

Fears that SWFs may pursue non-economic political or strategic objectives have raised concerns among policymakers (see below for further discussion of this in the Australian context). However, it should be recalled that foreign-owned businesses are subject to the same laws as their domestically-owned counterparts and so cannot engage in behaviour that is not also open to other firms. Anticompetitive conduct is typically regulated at a domestic rather than a cross-national level, and competition regulators have significant scope to address many of these issues. The tax authorities typically have significant powers to address transfer pricing issues. Certain assets or industries may potentially give rise to national security issues, but it needs to be demonstrated how foreign ownership gives rise to security issues that would not also be present in the case of a domestic investor. The Monitor Group's study of SWF behaviour suggests that SWFs have if anything avoided investments in politically sensitive sectors.[51] It is not in the interest of these funds to provoke protectionist sentiment. David Marchick and Matthew Slaughter observe that 'no one has pointed to a SWF investment that compromised national security in any country in the last five decades.'[52] Finally, it should be recalled that foreign-owned firms are always vulnerable to expropriation or nationalisation by host country governments, so the strategic and political risks associated with foreign direct investment by state-sponsored entities run in both directions. This creates a mutual dependence between foreign and host country governments that creates incentives for good behaviour on the part of SWFs and SOEs.

Many of these issues are being addressed at a multilateral level in an attempt to preempt the growing protectionist sentiment that has been observed into relation to cross-border investment by SWFs and SOEs. The OECD's Code of Liberalisation of Capital Movements recognises the right of member states to protect national security. The OECD Investment Committee has released guidelines for recipients of SWF investments as part of its Freedom of Investment, National Security and 'Strategic' Industries project, stating that 'OECD members have agreed that the national security clause of the OECD investment instruments should be applied with restraint and should not be a general escape clause from their commitments to open investment policies.'[53] The IMF has also been working on a code of best practice for sovereign wealth funds that is designed to address many of these concerns.[54] As Truman notes, more progress has been made in improving the transparency and accountability of SWFs than has been made by the recipients of SWF investments in clarifying their inward foreign investment regimes, a criticism that could be extended to Australia.[55] Having advised developing countries to become more open to foreign investment, it would seem hypocritical for developed countries to close their doors to foreign investment from emerging economies, notwithstanding the intermediation of that investment by state entities.

**Having advised developing countries to become more open to foreign investment, it would seem hypocritical for developed countries to close their doors to foreign investment from emerging economies.**

The Australian government should support these efforts, while recognising that the failure of the Multilateral Investment Agreement process in the 1990s points to the significant limitations of multilateral approaches to the further liberalisation of cross-border investment. It should ensure that its FDI regime and its own sovereign wealth funds, such as the Future Fund, adhere to internationally recognised principles. Unfortunately, according to the Peterson Institute's Scoreboard of Sovereign Wealth Funds, Australia's Future Fund gets the lowest score in terms of transparency and accountability among pension funds, below that of China's National Social Security Fund. Out of non-pension funds, the Future Fund scores less than the State Oil Fund of the Republic of Azerbaijan and only just above the National Fund for the Republic of Kazakhstan.[56]

## Foreign direct investment in the Australian mining industry

Foreign direct investment has played a critical role in the long-term development of the Australian mining industry, which has long been characterised by high levels of foreign ownership, although joint-venture arrangements between local and foreign firms have historically tended to dominate FDI in the mining sector. Australia faces an enormous investment expenditure task to capitalise on the global commodity price boom. The mining industry has consequently been the location for high-profile foreign investment proposals that have exposed some of the worst features of Australia's FDI regime. The early 1970s commodity boom saw a protectionist backlash against foreign investment in Australia and there is a risk of history repeating itself in the context of the more recent boom in commodity prices.

### *The Shell–Woodside Petroleum case*

Perhaps the most notorious case was the Howard government's decision on 23 April 2001 to reject a $10 billion bid by the Anglo-Dutch company Royal Dutch Shell to acquire Woodside Petroleum. By way of comparison, the current account deficit for the year ended in the June quarter 2001 was just under $17 billion, so the proposal would have notionally financed the bulk of the previous year's current account deficit. The proposed acquisition was blocked by the Treasurer on the grounds that Shell might not develop the North West Shelf (NWS) gas project, in which Shell and Woodside were joint venture partners.

The decision involved the Treasurer explicitly second-guessing the future business decisions of Shell in relation to these assets. In announcing his decision, Treasurer Costello said that:

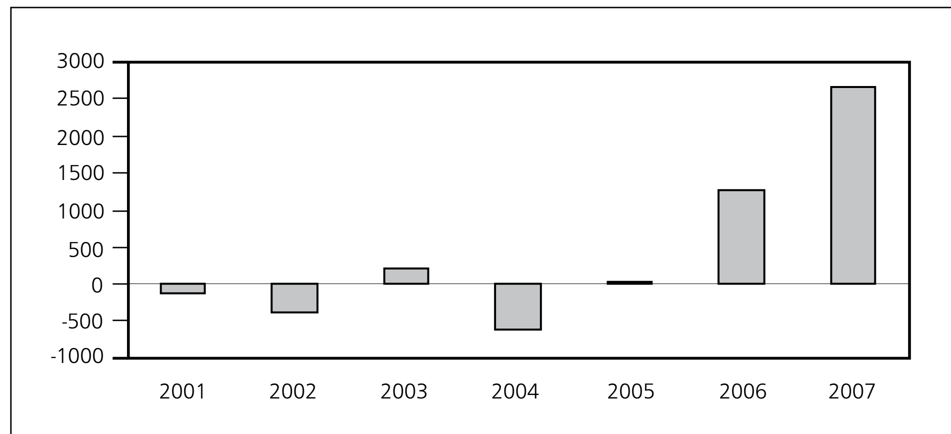
> I have the responsibility to make a decision that must as far as possible withstand circumstances which might change after my decision has been made. Such circumstances can involve changes in the corporate strategies of the parties involved in a decision, new or evolving corporate strategies by other companies with respect to the NWS project and changing world demand and supply conditions.[57]

There was never any reason to suppose that Shell would fail to develop these assets at the expense of others in its portfolio.[58] The reasons given for rejecting the acquisition could have been invoked in relation to almost any FDI proposal, since all such investments are subject to future uncertainty. The case highlighted the arbitrary and capricious nature of Australia's FDI regime. Global investors responded by immediately marking down the international value of Australian assets, with the Australian dollar exchange rate falling sharply. Seven years later, and following a change of government, Woodside is still seen as effectively off limits to foreign acquisition, with one journalist noting recently that 'any bid now would present a difficult decision for a new Labor government, and for that reason, some say a bid is highly unlikely.'[59]

### *Chinese investment in the Australian mining industry*

China has a long-standing interest in Australian mining assets that dates back to at least the mid-1980s.[60] Until 2006, however, Chinese investment in Australia, including FDI, was minimal. Indeed, China divested from Australia in calendar 2001, 2002 and 2004 (see figure 6).

**Figure 6.** Chinese (PRC) foreign investment transactions in Australia ($ million)




**Source:** Australian Bureau of Statistics[61]

Trade and foreign direct investment tend to be correlated. Given the strength of the bilateral trade relationship, China is arguably underinvested in Australia. China accounted for only 1.7% of FIRB approvals by value in 2006–07,[62] although this share is likely to rise.

As major consumers of Australian mining output, state-owned Chinese firms have shown a growing interest in acquiring mining assets through direct investment rather than following the more traditional joint venture path. The motivation for such acquisitions is largely commercial. For net consumers of commodities, an obvious hedge against rising commodity prices is to invest directly in commodity production. Japanese firms have for many years pursued a similar strategy built around joint ventures, perhaps best exemplified by the BHP Billiton Mitsubishi Alliance (BMA), now Australia's largest coal producer and exporter and the world's largest supplier of seaborne coking coal. Few could plausibly argue that BMA has hindered the development of Australia's coal resources.

**Chinese interest in Australian mining assets has served to illustrate the lack of clarity surrounding the application of Australia's FDI regime.**

It could be argued that because Chinese investment is taking place via listed entities, there is increased transparency compared to the joint venture approach to foreign investment that has been favoured historically. One reason for encouraging Chinese FDI in developed-country markets is that it forces increased disclosure and improved corporate governance practices on to Chinese firms, along with the need to satisfy foreign stock exchange listing requirements.

Concerns have been raised about extensive government ownership and control of Chinese firms. For example, the executive chairman of Chinalco, Xiao Yaqing, is also a member of the Central Committee of the Chinese Communist Party.[63] It has been suggested that Chinese interests might engage in strategic behaviour to obtain market power to influence prices in world markets. Recent Chinese acquisitions do indeed show evidence of strategic behaviour, but this is not necessarily anticompetitive. Chinalco's acquisition of a stake in Rio Tinto has been widely viewed as an effort to complicate BHP Billiton's attempted acquisition of Rio, as well as to acquire its aluminium assets. A BHP Billiton–Rio combination would command almost half of global iron ore production. The Australian Competition and Consumer Commission (ACCC) at one stage raised concerns about the prospective BHP–Rio merger on competition policy grounds. In this context, Chinese interest in Rio could even be seen as pro- rather than anti-competitive.

If prospective Chinese owners of Australian mining assets were to sell mining output to related entities at below market prices, this would be a cost to the Chinese owners of those assets. It would also seem unlikely that Chinese acquisitions in the global commodities sector could secure significant pricing power in world markets. The history of commodity markets is replete with failed efforts to corner the market. Chinese interests would be best served by increasing global

supply, which means developing resources to their maximum potential. This is compatible with the Australian interest in expanding mining output and export volumes while economising on the use of domestic capital.

Chinese interest in Australian mining assets has served to illustrate the lack of clarity surrounding the application of Australia's FDI regime. The Rudd government's effort to clarify Australia's policy on foreign direct investment on the part of government-related entities served only to create more confusion, as the new government flirted with new foreign ownership limits while failing to limit the scope of ministerial and bureaucratic discretion over FDI. In particular, there was confusion over whether the government would introduce a 49.9% ownership ceiling on stated-owned enterprises seeking to invest in Australia. Journalist Matthew Stevens reported on it this way:

> What we have here is a failure to communicate and it's a failure that risks temporarily tainting relations between Australia and our biggest trading partner. On the one hand, we have a small community of rich and powerful Chinese companies that believe they have been warned by elements within the Rudd government to expect the introduction of an ownership cap on their Australian aspirations. On the other hand, we have a federal government now delivering soundings that no ceiling is being considered and foreign investment applications will be considered on a case-by-case basis.[64]

The Chinese government-owned Sinosteel's attempt to acquire a stake in iron-ore explorer Midwest was the first hostile acquisition by a Chinese company in Australia. Sinosteel also sought FIRB approval to purchase Murchison Metals, a case which was subject to longer-than-usual delays as the government sought to formulate a position. As journalist Jennifer Hewett noted at the time, 'rejection of any immediate move by Sinosteel was formally made through Canberra's Foreign Investment Review Board … in reality, the move is a political decision coming directly from the Treasurer.'[65] Eventually, the government approved a 49.9% stake in Murchison Metals by Sinosteel, a decision that was designed to 'maintain diversity of ownership' in iron-ore assets in the Mid-West region.[66] The decision will likely revive Chinese suspicions that a de facto 49.9% limit is in place for Chinese FDI in the mining sector.

Chinalco's acquisition of a stake in Rio Tinto was also subject to considerable uncertainty. Chinalco's acquisition was in the London-listed entity and fell below the 15% threshold requiring FIRB approval. Chinalco notified the Australian government of the acquisition as a 'good will' gesture.[67] For its part, the Australian government maintained that all investment proposals involving foreign government-related entities require approval, but this criterion could be applied to almost all large Chinese firms. This runs the risk that Australia could be accused of conducting a discriminatory investment policy against China. China's ambassador to Australia said he was 'puzzled' by the delays in approving Chinese FDI into Australia and called on Australia to adopt a non-discriminatory approach to Chinese investment.[68] After significant delays, the Treasurer granted conditional approval for the acquisition of up to a 14.99% stake in Rio, with any further increase in equity requiring further approval, while Chinalco is also prevented from appointing a director to Rio while its shareholding remains below 15%.[69] The Treasurer gave no formal guidance on whether a larger stake would be in the 'national interest.'

According to Ian McCubbin, an Australian legal adviser to Chinese firms, 'some companies in China have redirected their investment interest to other countries as a result of the uncertainty' surrounding Australia's foreign investment regime.[70] The Treasurer's previous release of principles governing investment by state-owned entities on 17 February 2008, and a subsequent speech to the Australia China Business Council on 4 July 2008, did nothing to clarify the application of Australia's foreign investment policy to specific cases or to provide certainty for foreign investors. Drysdale and Findlay argue that the existing national interest test is adequate to handle the issues arising from state-owned Chinese FDI in the Australian mining industry, maintaining that the recent problems with the FDI approval process are due to the government 'departing from the well established and respected case-by-case approach.'[71] They maintain that 'there is no persuasive case for any change in direction over control of foreign direct capital flows in response to the recent

surge of interest of Chinese foreign direct investors in the Australian resource sector.'[72] In fact, there is little evidence to suggest that there has been a fundamental departure from past practice in the administration of Australia's FDI regime. The recent confusion in relation to Australian FDI policy is to be expected under a regime subject to sweeping ministerial and bureaucratic discretion, and highlights the need for fundamental reform of that regime.

## A new FDI regime for Australia

A new regulatory regime for FDI would need to be established by way of amendments to the FATA and related legislation. The regime should aim to maximise the opportunities for foreign direct investment in Australia. The regulation of FDI should be non-discriminatory, treating foreign investment on the same basis as domestic investment, to minimise distortions to the ownership and control of equity and other forms of capital. FDI should be subject to the rule of law rather than bureaucratic and ministerial discretion, providing certainty to foreign investors as well as the resident sellers of domestic assets.

To maximise the scope for foreign direct investment, existing statutory restrictions on foreign ownership should continue to be relaxed, in line with both domestic and international trends in relation to cross-border investment, as well as bilateral investment liberalisation commitments. This should include the removal of foreign ownership limits on Qantas, Telstra, domestic airports and other assets. The Productivity Commission should be tasked with investigating whether the current restrictions on foreign investment in developed urban real estate serve to augment or to limit the overall supply of residential and non-residential property. If the restrictions are found to limit supply, then they, too, should be removed.

In relation to the FDI approval process, there are two main options for reform. The first option would involve abolishing the FIRB and extending full 'national treatment' to foreign direct investment, meaning that FDI would be regulated in the same way as domestic investment. Rather than seeking to regulate FDI at the border, this approach entails regulating foreign-owned businesses through the same regulatory frameworks that apply to domestically owned businesses in Australia. Existing regulatory institutions are already well equipped to handle these issues. This approach would eliminate the duplication between the FIRB and other regulatory authorities such as the ACCC. The federal government would always retain the ability to legislate to control or proscribe specific investment proposals in given firms or industries. However, this would require parliamentary approval, significantly raising the hurdle to imposing new restrictions on foreign investment and ensuring that any new restrictions receive appropriate public scrutiny.

**The recent confusion in relation to Australian FDI policy is to be expected under a regime subject to sweeping ministerial and bureaucratic discretion.**

Given the depth and resilience of nationalist sentiment and capital xenophobia in Australia, politicians may be unwilling to abolish the existing FDI review procedure. A second option for reform is thus to focus on improving the operation of the existing FDI approval process rather than abolishing it. Under this option, the thresholds for the FDI review process could be raised to levels consistent with the provisions of the Australia–US Free Trade Agreement. This would yield a non-discriminatory application of these thresholds and reduce the number of foreign investment proposals requiring approval. The FIRB could continue to administer the review process, but would be placed on an independent, statutory basis similar to that for the Reserve Bank. Resources could be transferred from the Foreign Investment and Trade Policy Division of Treasury to FIRB so that the review process could be conducted more independently.

Under the second option, the current open-ended and discretionary 'national interest' test for review of FDI proposals would be removed from the FATA. The national interest test would be replaced with separate 'national security' and 'national economic welfare' tests. The Treasurer would refer proposals raising specific national security concerns to the National Security Committee of Cabinet for determination. Such referrals would be extremely rare, since few FDI proposals raise genuine national security issues. Application of the national security test should conform with

article 3, on public order and security, of the *OECD Code of Liberalisation of Capital Movements*, and related OECD guidelines.

The national economic welfare test would be applied by the FIRB in consultation with other agencies, such as the ACCC. Where issues of competition policy are involved, the ACCC should make the determination, to eliminate the current duplication of FIRB and ACCC oversight. The economic welfare test would determine whether the proposed investment was likely to yield net economic benefits to Australia. Most FDI proposals could be expected to pass this test. Adverse implications for specific firms and industries and government revenue could be traded off against economy-wide benefits. It would be incumbent upon the FIRB to make a plausible case for a net loss of economic welfare before an FDI proposal could be rejected. Where approval is given conditionally, the FIRB should be required to explain how these conditions will result in an improvement in economic welfare relative to unconditional approval. The use of a national interest test has generally been preferred over a net economic benefits test, on the grounds that the latter placed the burden on the foreign investor to demonstrate a net benefit, while the national interest test placed the burden on the commonwealth to explain why a proposal was not in the national interest. In practice, however, the undefined and open-ended nature of the national interest test places no real burden on the commonwealth. A net economic benefits test, by contrast, would require the commonwealth to advance economic arguments in support of its position.

**Reforming the FDI approval process … would serve to heavily circumscribe the scope of ministerial discretion over foreign direct investment.**

The FIRB's decision in relation to the national economic welfare test would be binding on the government of the day. At the same time, the FIRB's decision-making processes should be made more transparent and subject to administrative and judicial review. The government could still override the FIRB by passing specific legislation proscribing the proposed investment, but would need parliamentary approval, significantly raising the hurdle to blocking foreign direct investment proposals and ensuring that foreign direct investment is regulated by legislation rather than ministerial fiat. Reforming the FDI approval process along these lines would serve to heavily circumscribe the scope of ministerial discretion over foreign direct investment, although it would still leave in place some bureaucratic discretion over those FDI proposals still requiring approval.

Both reform options would provide a more robust and consistent framework through which to address the issues raised by the increased interest in Australian assets on the part of SWFs and SOEs. The current discretionary 'national interest' approach to regulating FDI will continue to raise suspicions of discriminatory treatment, while creating considerable uncertainty for foreign investors and the resident owners of Australian assets. It also unduly politicises decision-making in relation to FDI, leaving the administration of policy vulnerable to intervention by sectional, nationalist, and protectionist interests. In the absence of a regulatory regime that provides for complete national treatment of FDI, some bureaucratic discretion in the regulation of FDI is unavoidable. However, it is preferable that this discretion is exercised at arm's length from the government of the day, by an independent statutory body subject to high levels of transparency and systems of review.

## Conclusion

Foreign direct investment, along with foreign investment more generally, provides important economic benefits for Australia. FDI increases the domestic capital stock, results in more efficient ownership of that stock, and supports long-run improvements in productivity, laying the foundations for future economic growth and rising living standards. Cross-border direct investment thus has an even more profound impact on economic welfare than international trade in goods and services. Yet, on a range of measures, Australia is underperforming in terms of FDI inflows. The most likely explanation for this underperformance is Australia's relatively restrictive FDI regime. This includes outright statutory restrictions on foreign ownership, as well as sweeping bureaucratic and ministerial discretion to reject FDI proposals based on open-ended criteria that

are inconsistent with the rule of law, increasing uncertainty for foreign investors and Australian residents selling domestic assets.

The growing role of state-sponsored entities in the intermediation of cross-border capital flows has raised new concerns about foreign direct investment, both in Australia and abroad. In particular, concerns have been raised that state-sponsored entities may pursue political or strategic rather than purely commercial objectives. However, these concerns need to be put in perspective. Experience with SWFs and SOEs suggests that they are mainly motivated by commercial considerations and maximising returns on investment. To the extent that they pursue other objectives, the costs of such activity are mainly borne by the state-owned entities themselves rather than host economies. Foreign-owned businesses operating in Australia are subject to Australian law. They cannot engage in behaviour that is not already available to Australian firms. The Australian government retains significant powers under both competition and tax law to address many of these concerns, without having to rely on controlling investment at the border. Foreign-owned firms are always vulnerable to expropriation or nationalisation by host-country governments, so the strategic and political risks associated with foreign direct investment by state-sponsored entities run in both directions. This mutual interdependence is a powerful incentive for good behaviour on the part of foreign investors, and is consistent with the classical liberal view that free trade also promotes international harmony.

**The Australian government should continue to relax statutory and other restrictions on foreign ownership. This should be done independently of bilateral and multilateral trade and investment liberalisation commitments.**

The Australian government should continue to relax statutory and other restrictions on foreign ownership. This should be done independently of bilateral and multilateral trade and investment liberalisation commitments, although these commitments may provide additional opportunities to move forward with the liberalisation agenda and obtain leverage over the protectionist interests and nationalist sentiment that obstructs foreign direct investment and economic progress.

In relation to the FDI approval process, there are at least two major options for reform. The first would abolish the existing process altogether, extending full national treatment to foreign direct investment. Instead of regulating FDI at the border, the focus for policy would be on regulating foreign-owned businesses in Australia in the same manner as domestically owned firms. Australia's existing regulatory institutions are well equipped to perform this task. The Australian government can always legislate to further regulate or proscribe specific investment proposals where this might be deemed necessary. The need for parliamentary approval would ensure that such restrictions receive increased public scrutiny and that foreign direct investment is regulated by legislation rather than ministerial fiat.

If FDI is to be regulated at the border, then reform efforts should focus on further liberalising and improving the existing FDI approval process. The thresholds for review of FDI proposals should be raised to reflect recent trends in bilateral free-trade agreements. The FATA and related legislation could be amended to replace the current national interest test with distinct national security and national economic welfare tests. Federal cabinet would rule on investment proposals raising specific national security concerns. All other FDI proposals that reached notification and review thresholds would be considered by an independent, statutory FIRB, and would be subject to a national economic welfare test. The FIRB's decision in relation to the economic welfare test should be binding on the government of the day. This would remove ministerial discretion from the FDI approval process and increase certainty for foreign investors and the resident owners of domestic assets.

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