



Australian Government
Productivity Commission

Foreign Investment in Australia

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Research Paper

June 2020

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The Productivity Commission

The Productivity Commission is the Australian Government's independent research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians. Its role, expressed most simply, is to help governments make better policies, in the long term interest of the Australian community.

The Commission's independence is underpinned by an Act of Parliament. Its processes and outputs are open to public scrutiny and are driven by concern for the wellbeing of the community as a whole.

Further information on the Productivity Commission can be obtained from the Commission's website (www.pc.gov.au).

Foreword

To facilitate public debate about foreign investment, the Productivity Commission's 2016 inquiry into the *Regulation of Australian Agriculture* recommended that the Australian Government should request the Commission, in its annual *Trade and Assistance Review*, to report on the trends, drivers and effects of foreign investment. In 2019, the Australian Government supported this recommendation. This report forms a broad initial examination of Australia's foreign investment policies as part of that response, with subsequent *Reviews* anticipated to build on this work.

Evidently, this report is being released against the background of an unprecedented health and economic crisis due to the coronavirus (COVID-19) pandemic and heightened awareness of national security risks. The sweeping disruptions to businesses and expectations of a deep economic contraction have prompted some changes in Australia's foreign investment policies. The Australian Government announced on 29 March 2020 that *all* foreign investment applications will be subject to screening by the Foreign Investment Review Board for the duration of the pandemic. Permanent changes were announced in June to strengthen the national security assessment of foreign investments in sensitive sectors. The Commission has not analysed the impacts of these changes in detail, given the still unfolding situation and the highly uncertain outlook, but will consider the pandemic and national security measures, where relevant, in the next *Trade and Assistance Review*.

As the economy begins to recover after the pandemic passes, the role of foreign investment will be more crucial than ever. Many struggling Australian brands will be shielded from damage by foreign investment, while other businesses and employers will be able to recover faster if they have access to foreign funding and expertise. Government policy needs to continue to recognise and facilitate these benefits, even as it acts to mitigate the risks from some investments.

Jonathan Coppel
Commissioner

June 2020

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We also want to thank those government organisations for the time they spent responding to our questions and for providing information and data that helped inform our analysis. The Commission's modelling is its own and has not been verified by the relevant Departments, although it has been subject to comments by external referees.

The report was overseen by Commissioner Jonathan Coppel. Production of the report was led by Ben Dolman, and a team comprising Jacob Conway Smith, Aaron Mollross, and George Steel.

Abbreviations

ABS	Australian Bureau of Statistics
ACCC	Australian Competition and Consumer Commission
ASIO	Australian Security Intelligence Organisation
ATO	Australian Taxation Office
BEPS	Base erosion and profit shifting
CFIUS	Committee on Foreign Investment in the United States
CGE	Computable general equilibrium
CIC	Critical Infrastructure Centre
EU	European Union
FDI	Foreign Direct Investment
FIRB	Foreign Investment Review Board
G20	Group of 20
GDP	Gross Domestic Product
GNI	Gross National Income
NSC	National Security Committee of Cabinet
OECD	Organisation for Economic Cooperation and Development
PC	Productivity Commission
R&D	Research and Development
RBA	Reserve Bank of Australia
UNCTAD	United Nations Conference on Trade and Development
US	United States

OVERVIEW

Key points

- Over the past two centuries, foreign funding has supported Australia's economic development by permitting more capital investment than domestic savings would have otherwise allowed.
 - Foreign investment brings 'spillover' impacts too, both positive (access to new technologies, better management practices, increased competition) and negative (potentially less competition, social and environmental costs).
 - Foreign investment also stirs strong community reservations, although Australians are generally supportive of globalisation and free trade.
- To balance the economic benefits of foreign investment against the risks, and to maintain community confidence that foreign investment is in the national interest, Australia regulates foreign investment through a range of mechanisms.
 - Since 1974, foreign acquisitions with a value above certain thresholds are screened and require a decision of the Treasurer that they are not contrary to the 'national interest'. Recent changes have lowered these thresholds to zero for sensitive national security businesses.
 - Australia has a broadly open policy towards foreign investment, but is more restrictive than many other advanced economies, by some measures.
 - To the extent that foreign investment proposals are blocked or discouraged, this results in lower Australian household incomes — Commission modelling estimates that these economic costs would be material, though not large.
- Foreign investment policy has become more prominent over recent years. Greater attention is being given to the difficulty of taxing multinationals and the national security risks associated with sensitive sectors or critical infrastructure assets — as, for the first time, one of our largest sources of investment is not a democracy or a military ally.
- Policy change in response has been piecemeal. Monetary thresholds for screening vary by source country, sector and type of investor, while the use of approval conditions is increasing.
 - The role of the Foreign Investment Review Board has become more akin to a regulator than a gatekeeper, yet its powers and institutional arrangements have changed little.
- Overall, the design and vesting of responsibility with the Treasurer for administering the 'national interest' test works well. It gives flexibility to quickly adapt to new concerns, weighing up not just the costs, but also the benefits from foreign investment. The 'negative' nature of the test (deciding whether proposals are *contrary* to the national interest) also limits the risk of rejecting projects that are in the national interest. These features should be retained.
- Other aspects of the foreign investment policy framework could be improved.
 - The national interest test lacks clarity around how it is interpreted from case to case. Tighter policy guidance and excluding risks from the test that can be mitigated through national regulations (such as competition) would lower compliance costs and lift investor certainty.
 - Attaching conditions to foreign investment approvals provides only a limited means to mitigate risks. National laws and regulations, together with purpose-built and adequately-resourced regulators (such as the Australian Competition and Consumer Commission, or the Critical Infrastructure Centre), where available, should be preferred.
- Publication of reasons for decisions to block proposals, greater certainty around timelines, and aligning applications fees with the actual cost of administering the screening regime would increase transparency, enhance predictability and lower the costs of the screening regime.

Overview

About this project

The Commission's 2016 inquiry into the *Regulation of Australian Agriculture* found that, despite the benefits of foreign investment to agriculture (and the economy), it attracts considerable negative public attention. To facilitate a more informed public debate about foreign investment, the Commission recommended that the Australian Government should request the Productivity Commission, in its annual *Trade and Assistance Review*, to report on the trends, drivers and effects of foreign investment.

In 2019, the Australian Government supported this recommendation. This report forms a broad initial examination of Australia's foreign investment policies, with subsequent *Trade and Assistance Reviews* building on this work through closer examination of recent developments and more specific policy issues.

Trends in foreign investment

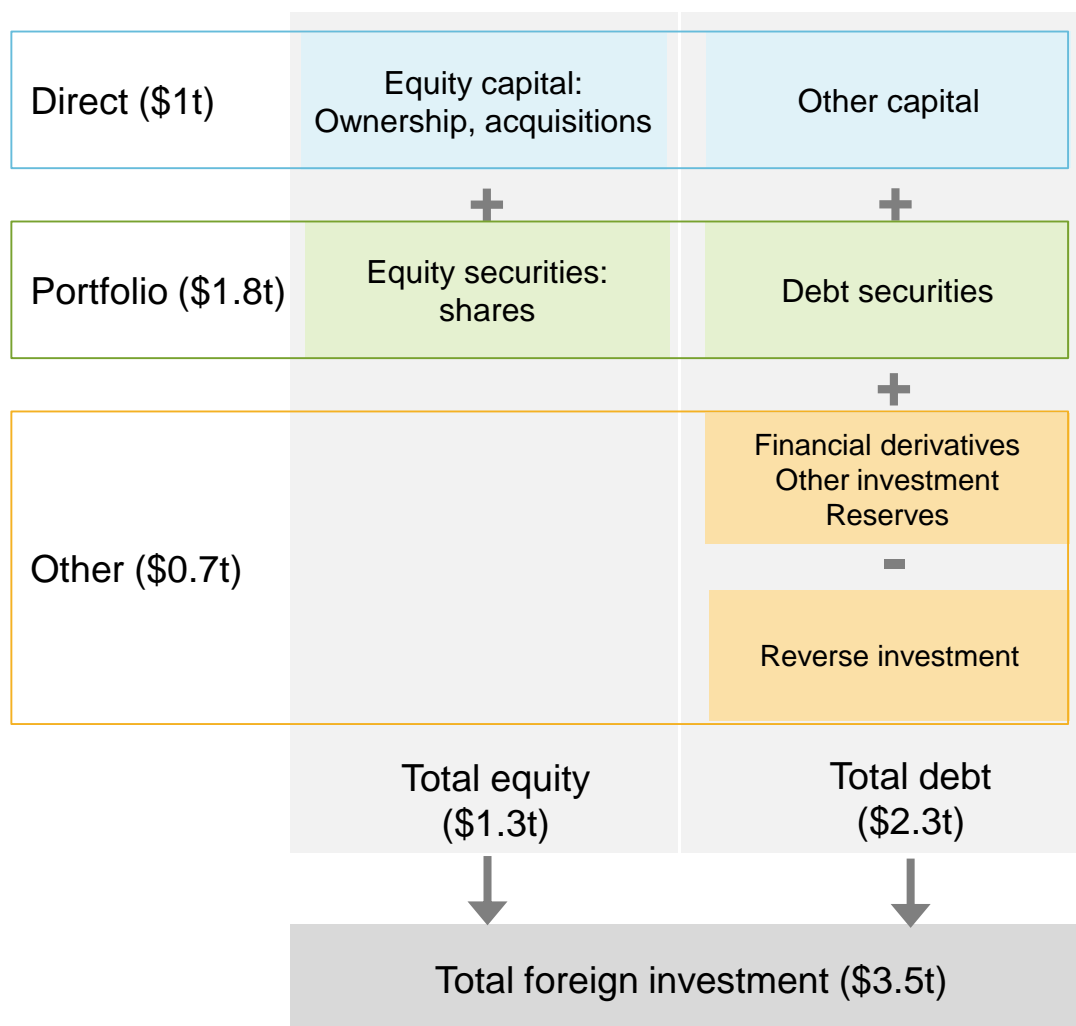
Australia is an attractive destination for foreign investment

Australia has, since 1788, been a recipient of net foreign investment in most years. Foreigners invest in Australia because of our fast-growing and well-educated population, rich natural resource base, and stable cultural and legal environment.

The Australian Bureau of Statistics (ABS) estimates that foreign-owned capital located in Australia amounts to \$3.5 trillion, while Australians own about \$2.5 trillion of capital located overseas. These foreign investment figures include debt, derivatives and equity investment (figure 1).

Foreign *direct* investment (FDI) is the portion of these holdings that is accompanied by a degree of foreign *control*, defined as an investor with at least a 10 per cent voting share over major company decisions. This is distinguished from portfolio investment, where the owner is a common creditor or shareholder that cannot make decisions, or directly influence decisions taken by the business.

Figure 1 The different kinds of foreign investment
By Australian inward foreign investment stocks, at December 2018^a

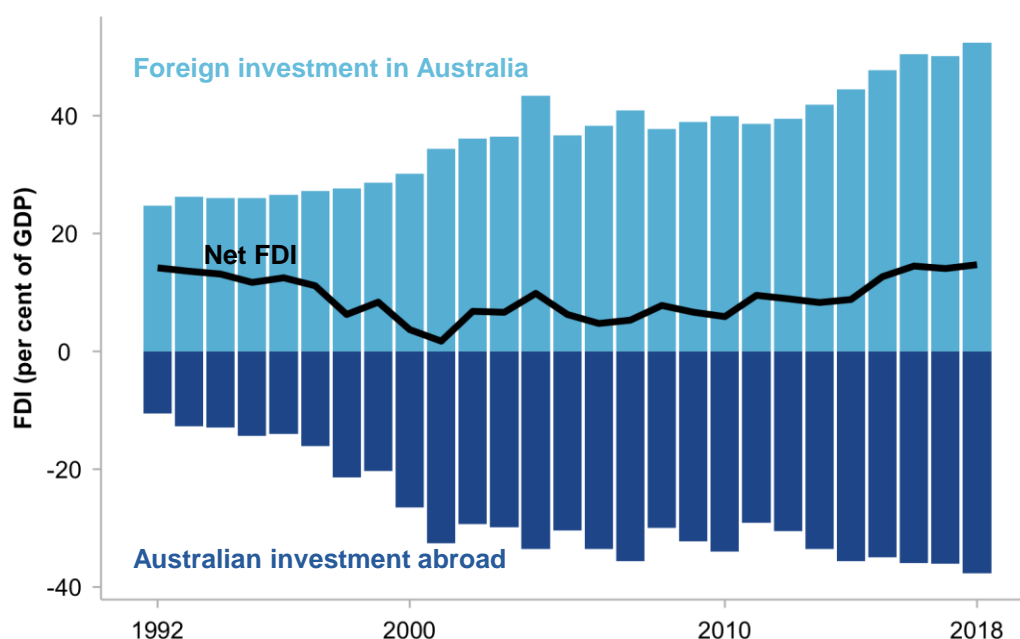


^a The sum of total equity and debt equals total foreign investment. Discrepancies due to rounding.

Source: ABS, *International Investment Position, Australia: Supplementary Statistics, 2018*, cat. no. 5352.0 (table 2).

Australia's inward stock of FDI totalled \$967.5 billion at December 2018, or 52 per cent of gross domestic product (GDP), following strong net inflows since 2001 (figure 2). To put these estimates in context, the value of physical assets in the Australian economy (excluding housing) is estimated to be about \$6 trillion, and aggregate household net wealth is about \$10.5 trillion.

Figure 2 Foreign direct investment in Australia has risen strongly^a
Inward and outward FDI stocks relative to GDP



^a The significant transactions in December 2004 and June 2005 were due to a large corporate group restructure, with the eventual transfer of its Australian subsidiaries moving offshore.

Sources: ABS, *International Investment Position, Australia: Supplementary Statistics*, cat. no. 5352.0 (various years) and Commission estimates.

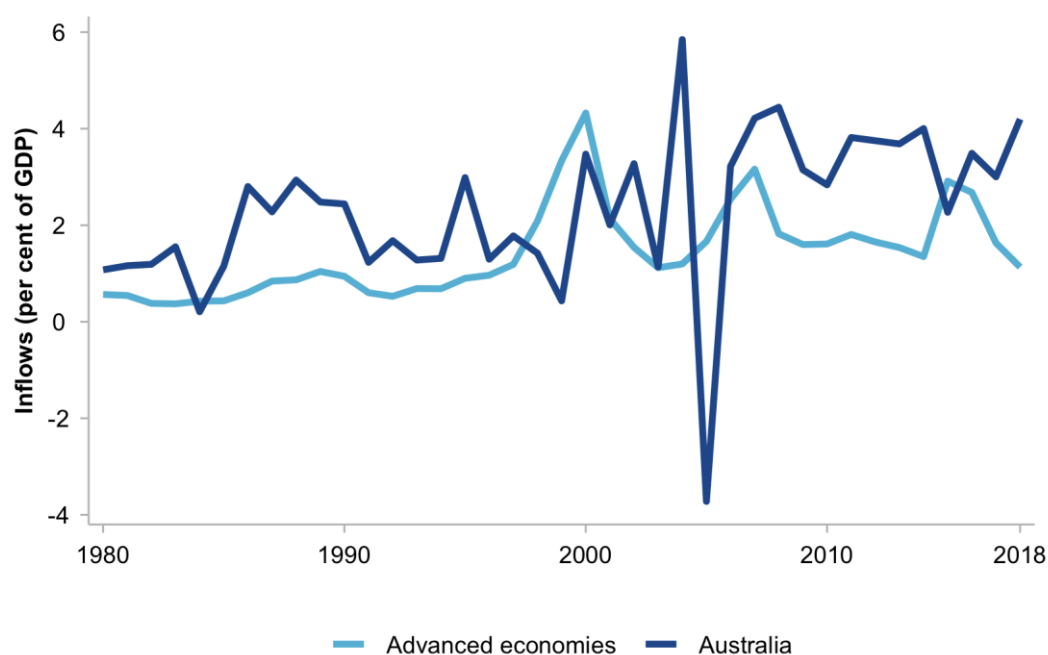
The growth in FDI into Australia contrasts with flatter global trends since the financial crisis (figure 3). Global statistics have also been affected by changes in US company taxes in 2018, which have encouraged repatriation of profits (a form of negative outward investment for the United States).

Australian investors also own and control a substantial amount of assets and enterprises abroad, mostly in the financial and insurance services, mining and manufacturing industries. At the end of 2018, Australia's outward FDI stocks had reached \$696 billion, equivalent to 38 per cent of GDP (figure 2 above).

Overall, this means that Australia has been a net recipient of FDI, with the gap (net inward FDI) equivalent to about 15 per cent of GDP in 2018. This is up from a low of 2 per cent in 2001, with the increase driven by inward FDI growth, rather than any large decrease in outward FDI.

Figure 3 **Australia bucks the global trend**

Inflows of FDI relative to GDP^a



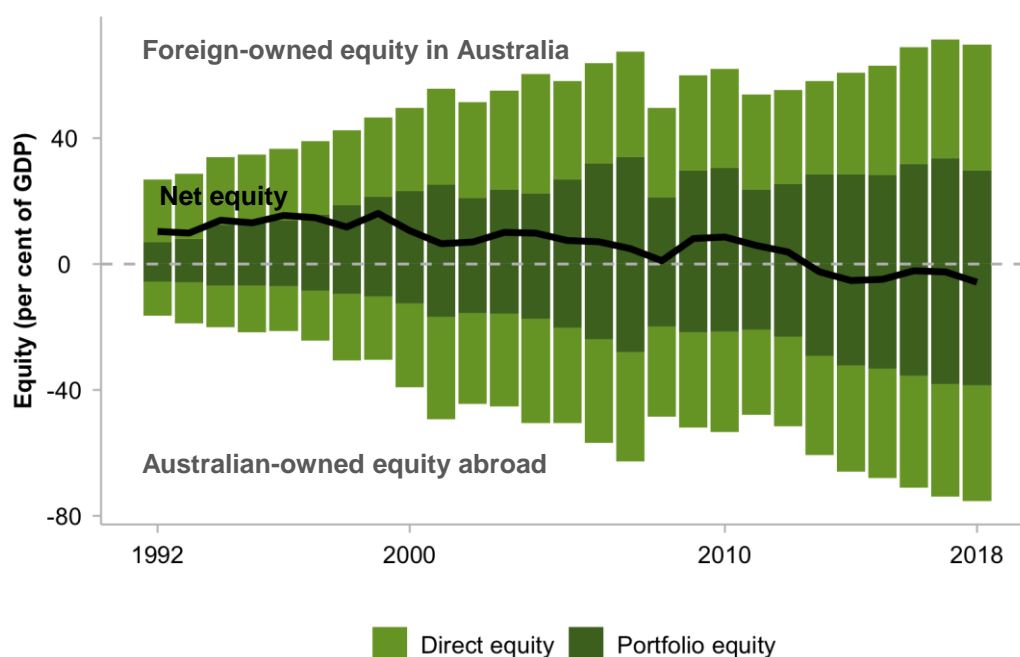
^a The significant transactions in December 2004 and June 2005 were due to a large corporate group restructure, with the eventual transfer of its Australian subsidiaries moving offshore. 'Advanced economies' refer to the World Bank's standard of classification.

Source: UNCTAD (2020).

More broadly, Australia's equity position has also changed, recently switching to a positive net equity position, due to portfolio investment by Australian superannuation funds seeking higher returns abroad (figure 4). That is, Australians are increasingly net owners of foreign businesses, with net equity investment now standing at about 6 per cent of GDP (\$250 billion).

At the same time, Australia's debt to the world is increasing, due to wholesale loans to the domestic banking sector (which are largely used for residential mortgages in Australia). Together, these two trends show that foreign investment can provide benefits to Australians both as a source of additional capital for domestic investment, as well as an opportunity to diversify our savings.

Figure 4 **Australians now own more equity abroad**
Net foreign equity position^a



^a Total Australian equity owned by foreigners less total foreign equity owned by Australians.

Sources: ABS, *International Investment Position, Australia: Supplementary Statistics*, cat. no. 5352.0 (various years) and Commission estimates.

The costs and benefits of foreign investment

Foreign investment into Australia means that more capital is deployed than would have been possible if funded solely through domestic savings. In effect, foreign capital lowers the cost of capital for domestic investments, increasing the number of viable investments for both businesses and households (such as through lower mortgage rates).

The other way in which foreign direct investment benefits Australians is through ‘spillover’ benefits that ultimately improve living standards. This is particularly the case with commercial *direct* investment, which comes with greater engagement from multinationals, including use of their intellectual property, international logistics networks and management expertise. The technology, innovation and technical know-how of these multinationals tends to leak into the rest of the economy as a spillover effect, leading to improved productivity for local firms through the direct transfer of advanced technology, enhanced competitive pressures on domestic firms, and greater human capital development. Although these spillover benefits are hard to accurately quantify, decades of economic research suggest they are significant.

Foreign investment can be associated with negative spillovers too, where an investment has adverse repercussions for the broader economy and community. Some negative effects are in fact the downside of otherwise positive outcomes for Australia (such as increased competition), while other impacts relate to ongoing worries about whether foreign investors will adhere to Australia's social and environmental regulations.

Foreign investment also stirs strong community reactions. While Australians are generally supportive of globalisation and free trade, many members of the community express reservations about Australia's openness to foreign investment. In polls of community attitudes, large majorities of respondents consistently state that foreign investment is a threat to Australian interests, and agree that there should be more restrictions on foreign ownership. As one commentator noted:

Not many political issues stir the emotions in the way that foreign ownership does. It is a subject that provokes deep, visceral feelings of possession, solidarity and national identity. (Switzer 2008, p. 4)

Australia's foreign investment policy

To balance the economic benefits that foreign investment can bring against the risks, and to maintain community confidence, the Australian Government regulates inward foreign investment through a range of mechanisms.

The core of the Government's policy is a broad foreign investment screening regime. All foreign acquisitions that exceed prescribed monetary thresholds (table 1) are subject to screening (in response to the COVID-19 pandemic, the Government has temporarily reduced all monetary thresholds to \$0 — box 1). For investments over the threshold, the Treasurer considers whether there is evidence that they are contrary to Australia's 'national interest', or if the Treasurer takes no action they are deemed approved after statutory time periods. If the Treasurer forms the view that the foreign investment is contrary to the national interest, they can:

- make an order to prohibit the investment going ahead
- allow the investment, but impose conditions
- order disposal of the investment if it has already gone ahead.

The concept of national interest is not defined in law, but policy documents indicate that, when assessing the national interest, the Government normally takes into account:

- national security, based on assessments from our security agencies
- competition, particularly whether the acquisition may allow control of the supply of a product into the domestic market
- the tax and environmental impacts of investments
- the impact on the economy and community, including employees, creditors and other stakeholders

-
- the character of the investor, including whether they operate on a transparent commercial basis and are subject to transparent regulation and supervision in their home country.

Treasury provides secretariat services to the Foreign Investment Review Board (FIRB), which in turn advises the Treasurer on foreign investment decisions. The Treasurer also delegates non-controversial decisions that are consistent with the policy framework to junior ministers and senior Treasury and Australian Taxation Office (ATO) staff. Since 2015, the ATO has been responsible for administering residential real estate assessments.

Box 1 Recent changes to foreign investment policy

On 29 March 2020, the Treasurer announced that the Government would be screening all foreign investment into Australia for the duration of the COVID-19 crisis. To allow time to screen applications, FIRB will extend the timeframes for screening from 30 days up to 6 months, but will prioritise investments that ‘protect and support Australian businesses and jobs’.

The Treasurer said that these measures were necessary to ‘safeguard the national interest as the coronavirus outbreak puts intense pressure on the Australian economy and Australian businesses’ (Frydenberg 2020a).

In June 2020, the Australian Government announced major reforms to Australia’s foreign investment policy. These reforms would be permanent replacements for the temporary COVID-19 measures. The reforms included:

- introducing a new national security test for foreign investment that raises national security concerns and falls beneath the screening threshold for the national interest test
- requiring mandatory notification of proposed foreign investment in a ‘sensitive national security business’ (to be defined in regulation after consultation, but anticipated to include critical infrastructure, businesses involved in the manufacture or supply of defence or national-security related goods, businesses that own, store, collect or maintain sensitive data relating to national security or defence, and others)
- creating a new ‘call in’ power to allow the Government to review an investment not otherwise required to be screened or notified, and a ‘last resort’ review power to reassess approved investments where subsequent national security risks emerge

The Government also announced stronger penalties, compliance and enforcement powers, the intention to develop a new register of foreign ownership and a review of application fees. The Government said that it intended the reforms to commence 1 January 2021.

Table 1 Foreign investment screening thresholds

	<i>Threshold — partner countries subject to higher threshold^a</i>	<i>Threshold — other countries</i>
	<i>\$ million</i>	<i>\$ million</i>
Residential real estate or vacant land	0	0
Developed commercial real estate	1 192	275
Business acquisitions in non-sensitive sectors	1 192	275
Business acquisitions in sensitive sectors ^b	275	275
Agricultural land	1 192 ^c	15 ^d
Agribusinesses	1 192	58
Foreign government investors: all direct investments, new business proposals and interests in land	0	0
Business acquisitions in sensitive national security sectors ^e	0	0

^a Currently applies to investors (other than in agricultural land) from Canada, Chile, China, Japan, Mexico, New Zealand, Singapore, South Korea, the United States and Vietnam, and any country for which the Comprehensive and Progressive Agreement for Trans-Pacific Partnership subsequently comes into force.

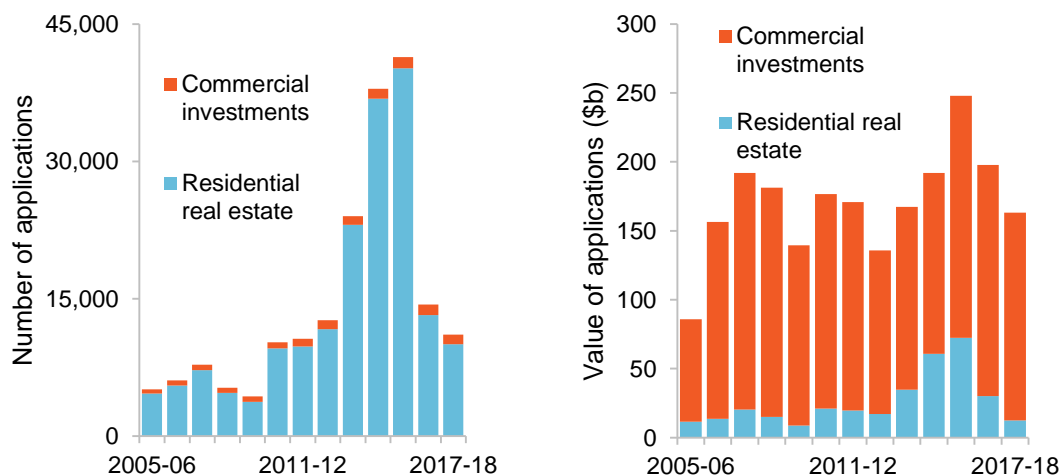
^b Sensitive sectors are media, telecommunications, transport, defence and military-related industries, encryption and securities technologies and communication systems, and the extraction of uranium or plutonium or the operation of nuclear facilities. ^c For Chile, New Zealand and the United States. ^d For Thailand \$50 million. ^e Subject to legislative amendment.

Source: FIRB (2020a).

In June 2020, the Australian Government announced that it would be creating a new ‘national security’ test for investments that raise national security concerns and which fall below existing monetary thresholds.

In 2017-18, the number of applications was 11 855, with 11 145 approvals at a total value of \$163 billion. Residential real estate makes up the majority of approvals — accounting for about 90 per cent of the number of approvals in 2017-18 — but only about 7.5 per cent of their value. The number of applications in 2017-18 was sharply lower than the peak of over 43 000 in 2015-16 (figure 5).

Figure 5 FIRB application numbers spiked then dipped, but aggregates are driven by real estate investment



Source: FIRB annual reports (various years).

The decline in the number of applications may have occurred for several reasons. Investors may have avoided making multiple speculative applications for potential residences since the introduction of application fees, foreign investment into Australian real estate may have been discouraged by the stamp duty and land tax surcharges introduced in recent years, or investment from China may have been restricted by a tightening of Chinese regulation on outward investment.

Australia also applies specific foreign ownership restrictions in some sectors. Many of these equity restrictions prohibit majority ownership by foreign investors collectively and in some sectors there are ownership limits for individual foreign investors. The legislated ownership restrictions operating in Australia are:

- aggregate foreign ownership in an Australian airline (including Qantas) is limited to 49 per cent (with any one foreign holding capped at 35 per cent)
- the *Airports Act 1996* limits foreign ownership of some airports to 49 per cent, with a 5 per cent airline ownership limit; and cross-ownership limits (where a foreign investor owns more than 15 per cent of Sydney airport) between Sydney airport and either Melbourne, Brisbane or Perth airports
- the *Shipping Registration Act 1981* requires a ship to be majority Australian-owned if it is to be registered in Australia
- aggregate foreign ownership of Telstra is limited to 35 per cent and individual foreign investors are only allowed to own up to 5 per cent.

Finally, regarding Australian real estate, foreign non-residents can only invest in residential property if that investment (directly) adds to the housing stock — that is, established

dwelling cannot be purchased.¹ Temporary residents can only buy an established dwelling if it is used as their residence and sold when they leave Australia.

The effect of restrictions on foreign direct investment

Australia's foreign investment policy is likely to have a material effect on the volume of foreign investment, although statistics can be difficult to interpret.

Foreign investment is rarely blocked outright — between 2015 and 2018 only 10 applications out of 108 990 were rejected (table 2). However, the low rejection rate may be partly explained by the screening regime discouraging some investors from applying at the outset, due to the costs and uncertainty created by the process. The size of this effect is not directly observable, although it can be modelled (discussed below).

Similarly, withdrawal may pre-empt a likely rejection, deflating the rejection rate. On average, about 5 per cent of applications are withdrawn prior to a decision, although it is difficult to know whether an application is withdrawn due to likely rejection or for other commercial reasons (such as more than one applicant pursuing the same asset, or a change in the commercial viability of a project).

Table 2 Applications and rejection and withdrawal rates

<i>Financial years^a</i>	<i>Rejection rate (% of applications)</i>	<i>Rejections</i>	<i>Withdrawal rate (% of applications)</i>	<i>Withdrawals</i>	<i>Applications</i>
1979–1984	2.89	255	4.76	420	8 829
1985–1990	1.90	332	6.01	1 049	17 449
1991–1996	1.79	470	7.50	1 970	26 279
1997–2002	1.87	524	7.78	2 220	28 537
2003–2008	0.57	209	6.81	2 129	31 274
2009–2014	0.06	62	2.93	3 055	104 247
2015–2017	0.01	10	3.90	2 733	70 058

^a Financial years beginning in the years indicated.

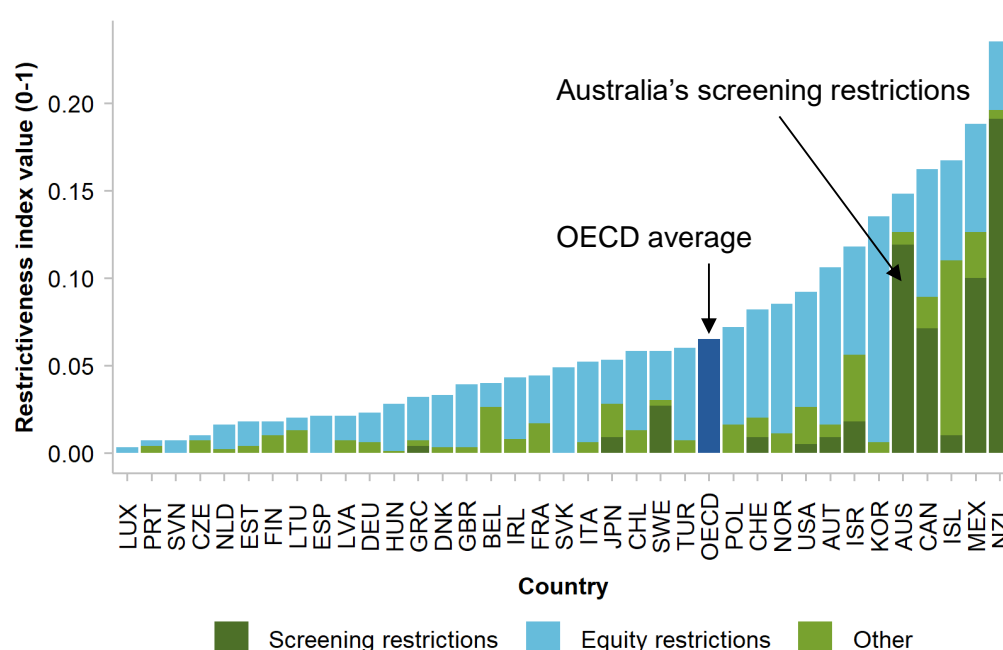
Source: FIRB annual reports (various years).

Comparing Australia's policies to regimes elsewhere, the Organisation for Economic Cooperation and Development's (OECD's) index of FDI restrictiveness places Australia well above the OECD average, though still lower than Canada and New Zealand (figure 6). However, the index also shows that Australia's regime is not overly restrictive in absolute terms (a score of 0.149, compared with a maximum of 1.0). The OECD also notes a decline in Australia's restrictiveness since 1997 (when the score was 0.2), in line with a broad trend across the OECD.

¹ The possibility that foreign investors add to the housing stock indirectly (e.g. if a vendor of an established dwelling uses the funds to invest in a new dwelling) is not considered by Government policy.

There are some limitations with the OECD index. For instance, it uses a subjective assessment to weight the strength of statutory restrictions, it does not include screening that is strictly for national security purposes, and it does not measure how statutory restrictions are enforced.

Figure 6 **Australia is generally open to FDI, but is less open than other OECD countries^a**
OECD FDI restrictiveness index, 2018



^a The restrictiveness index is between 0 (least restrictive) and 1 (most restrictive), aggregated across sectors
Source: Mistura and Roulet (2019).

However, the index has its strengths too, particularly as a synthetic metric to compare foreign investment policies across countries. This facilitates empirical analysis to measure the economic effects of different investment policies. Although there is uncertainty around the precision of the restrictiveness metrics, the econometric evidence is that the index is negatively associated with foreign investment.

Quantifying the effects of FDI restrictions

A range of studies have tried to quantify the effects of FDI restrictions on the Australian economy. All of these studies have shown that foreign investment leads to higher GDP, the benefits of which are partly remitted to foreign owners of Australian capital and partly enjoyed by Australians through higher wages and higher tax receipts. For example, the

Treasury found that a one-quarter drop in capital inflows would decrease the long-run capital stock by 1.5 per cent, gross national income (GNI) by 0.6 per cent, and real wages by 2 per cent, leading it to conclude that, ‘other things being equal, restrictions on capital inflow would reduce the wellbeing of Australians’ (Gali and Taplin 2012, p. 16).

For this report, the Commission has undertaken new modelling to quantify the economic effects of FDI restrictions. The modelling approach involves two steps.

- The first step relies on OECD work that estimated the change in FDI stocks as a result of changes in the OECD’s restrictiveness index, using a cross-country panel of foreign investment data (Mistura and Roulet 2019). That research found that a 10 per cent increase in the OECD’s restrictiveness index was associated with a decrease in inward investment stocks of 2.1 per cent.
- In the second step, the Commission used these estimates as inputs into the PC Global computable general equilibrium model, to test a scenario where Australia’s foreign investment policy is more restrictive. The exact nature of the added restrictions on foreign investment are not specified or modelled. However, to provide a plausible scenario, New Zealand’s restrictiveness index score is used as a proxy (the most restrictive country in the OECD). This would equate to an increase of about 60 per cent in Australia’s restrictiveness index.

Overall, the modelling estimates indicate that the cost of added foreign investment restrictions to Australians is material, though not large in the context of Australia’s nearly \$2 trillion economy. Increasing Australia’s restrictions on foreign investment (to a similar level of restrictiveness as New Zealand) would reduce GNI by between \$0.8 and \$7.1 billion (or \$82–\$731 per household per year), due to a loss of \$19–\$182 billion of net foreign capital.

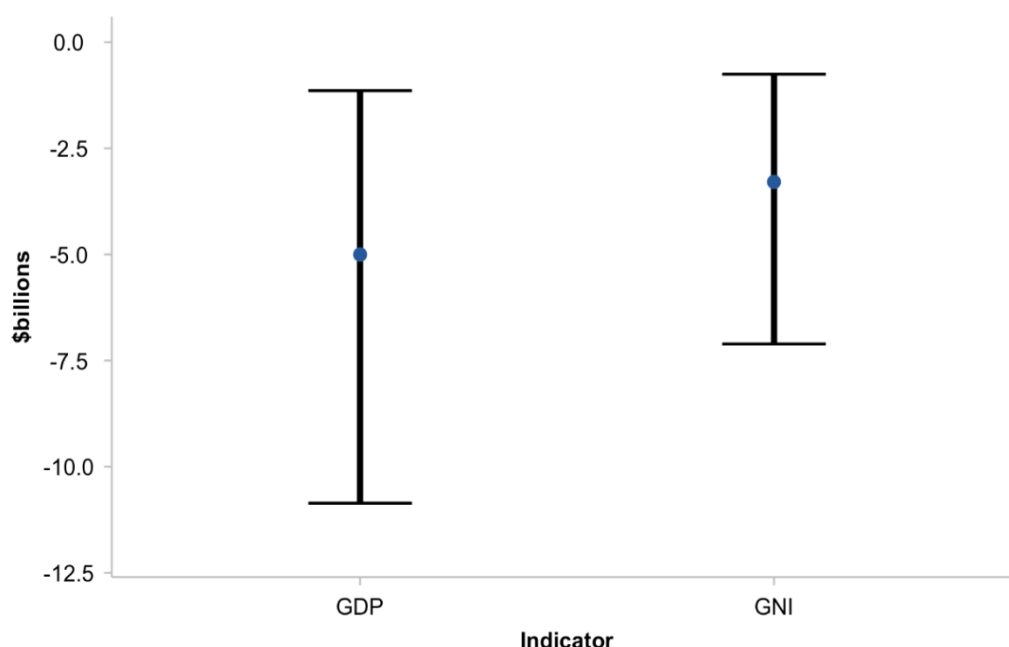
As with any modelling exercise, there is uncertainty around these estimates. One source of uncertainty is the accuracy of the estimates of the elasticity of investment to changes in restrictiveness. For this reason, a sensitivity analysis is presented using upper and lower estimates from a 95 per cent confidence interval (figure 7). Other sources of uncertainty include the subjective measurement of the restrictiveness of country’s FDI regimes, and the accuracy of modelling assumptions within the PC Global model (appendix A contains a more detailed methodology and analysis).

The Commission’s modelling estimates are also conservative — they do not capture the broad array of spillovers that, on the whole, are likely to exacerbate the negative effect of added restrictions on Australian incomes.

Figure 7

Restricting FDI hurts the Australian economy

Simulations of the effect on the Australian economy of adopting a more restrictive FDI regime, similar to the level of New Zealand^b



^a Percentage changes from the model are applied to current Australian gross domestic product and gross national income levels. ^b Error bars show high and low sensitivity tests based on estimates of the elasticity of foreign investment to FDI restrictiveness that are two standard deviations above and below the central estimate.

Source: Commission estimates.

Contemporary concerns in foreign investment policy

Foreign investment policy has become more prominent over recent years. Greater attention is being given to national security risks associated with sensitive sectors or critical infrastructure assets, as well as to the difficulty of taxing multinationals.

National security

National security concerns linked to foreign investment have become a focus for policy makers around the world. Many countries have introduced new screening regimes on national security grounds (e.g. Canada in 2009, Germany in 2009, Italy in 2012), while others have revised screening guidelines, thresholds or equity restrictions on sensitive sectors.

In Australia, Chinese investment has attracted particular attention. For the first time in Australia's history one of our largest sources of investment is not a democracy or a military ally (box 2).

Box 2 **Some Chinese investment has raised national security concerns**

There are several recent examples of Chinese investment in Australia that have raised security concerns from FIRB or the broader national security community.

- There were objections from the United States in November 2015, when the NT Government sold a 99-year lease on the **Port of Darwin** to Landbridge, a privately-owned Chinese company. The concerns were attributed to the surveillance and espionage capabilities presented by the port's close proximity to Australian and United States defence facilities, as well as concerns about the strategic purpose of China's investment in the region as part of its Maritime Silk Road.
 - Although FIRB was asked to look at the deal by the NT Government, it had no authority to intervene, as an acquisition from a state/territory government was outside of its remit at that time. In response, the Government amended the Foreign Acquisitions and Takeovers Regulation 2015, allowing FIRB to intervene in similar deals in the future.
- In 2016, the NSW Government attempted to sell 50.4 per cent of **Ausgrid** on a 99-year lease to the State Grid Corporation (a Chinese state-owned enterprise) and Cheung Kong Infrastructure Holdings (a privately-owned Hong Kong company). The sale was blocked by the Treasurer in August 2016 on national security grounds, allegedly because Ausgrid hosted infrastructure crucial to the joint Australia-US surveillance facility at Pine Gap, in the Northern Territory.
- A bid for **OZ Minerals** in March 2009 by state-owned China Minmetals was initially rejected by the Treasurer, due to the inclusion of the Prominent Hill mine in South Australia, located in the Woomera Prohibited Area defence zone. The deal with China Minmetals proceeded in April 2009, after the mine was excluded from the sale.

National security risks linked to foreign investment and the restrictions imposed by governments around the world generally reflect the nature of the risks, their prominence and the specific circumstances at the time. For example, they may consider the:

- dependency on foreign-controlled suppliers, creating opportunities for the supplier to delay, deny, or place conditions on the provision of crucial goods or services
- transfer or leakage of sensitive national security technology or expertise to a foreign-controlled entity
- creation of an additional channel for infiltration, espionage or sabotage by a foreign power.

Recently, the control of personal data has become an additional cause for concern among the national security community, with worries that data could be used to build up profiles of Australian citizens and coerce specific targets or influence the population.

These are all plausible threats, although none of them *require* foreign investment to occur. For example, infiltration, espionage or sabotage can occur through the employees and supply chains of Australian-owned businesses, as well as unconnected agents,² while personal data

² Indeed, the former Chief of the Defence Force observed that 'I can sit at the fish and chip shop on the wharf at the moment in Darwin and watch ships come and go, regardless of who owns it [the port]'.

held by Australian-owned companies can be just as vulnerable to hacks, breaches and leaks through inadequate security or data protection as data held by foreign owned companies.

The relevant question for FIRB's review is the extent to which allowing the investment increases the likelihood of security risks over and above the pre-existing risk in the absence of any foreign investment. There will be some cases where there are imperative national security risks associated with a foreign investment, and blocking the investment will be appropriate. In other cases, a low level of national security risk need not stop an investment that brings economic and other benefits to the country. Rather, monitoring and national regulation of the risks is likely to be a more efficient approach — the creation of the Critical Infrastructure Centre in 2017 is an example of one such means of regulation.

Multinational tax minimisation

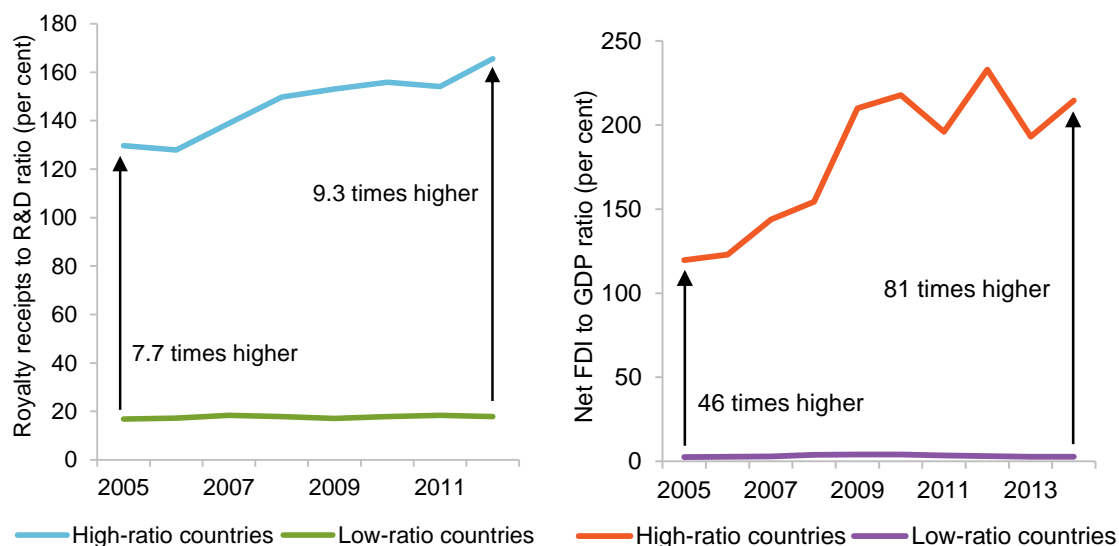
The global output and profitability of multinationals cannot readily be ascribed to operations in a particular country. Some multinationals are able to use a range of tools to relocate where profits are reported for tax purposes, including through choices about where they hold their debt ('thin capitalisation') and the pricing of goods, services and intellectual property between group companies ('transfer pricing').

The OECD-G20 work on base erosion and profit shifting (BEPS) over the past decade indicates that multinationals are becoming increasingly aggressive in their use of tax minimisation strategies. For instance:

- the profit rates of multinational affiliates in lower-tax countries are higher than their group's average worldwide profit rate
- FDI is increasingly concentrated in a few (mostly low-tax) jurisdictions (figure 8)
- there is some evidence of an increased transfer of intellectual property (IP) to favourable holding locations, as the ratio of royalty receipts to research and development spending has increased sharply in some countries (figure 8)
- effective tax rates paid by large multinationals are estimated to be 4 to 8½ percentage points lower than similar domestic-only enterprises.

In some cases, foreign investment can result in new risks of tax minimisation, as a previously domestic-only business would now have opportunities for BEPS through an acquiring multinational enterprise. Although the ATO has broad anti-avoidance powers and the Government has been engaging in international cooperation and coordination to close or reduce gaps between jurisdictions, the FIRB screening process is increasingly being used as a tool to prevent tax avoidance, particularly through the use of 'tax conditions' on approvals.

Figure 8 Multinational tax minimisation is a growing problem^a



^a Both indicators are circumstantial evidence of tax minimisation. The left hand figure shows that countries that already had high royalty to R&D ratios (an indicator that IP developed elsewhere is being parked in that country, presumably for tax reasons) have seen these ratios increase. The right hand figure shows that countries that had high net FDI to GDP ratios (an indicator that they host assets without corresponding real business activities, presumably for tax reasons) have also seen these ratios increase.

Source: OECD (2015, pp. 51, 62), updated from OECD (pers. comm. 19 March 2020).

Getting the balance right

The Australian Government's foreign investment policy aims to balance the economic benefits of foreign investment against the risks and the need to reassure the community that the national interest is being protected. The policy and its administration should achieve its objectives at minimum cost, which requires good regulatory practice.

The Commission has tested four key aspects of the foreign investment policy against good regulatory practice principles (box 3): the appropriateness of the 'national interest' test and the role of the Treasurer as decision-maker; the use of conditions on foreign investment approvals; the certainty and transparency of the screening process; and the application fees.

Box 3 **Good practice regulation**

The principles of good regulatory practice are well-established. The OECD has outlined how these principles apply to investment policies (in relation to national security):

- non-discrimination — treating similarly situated investors similarly
- transparency and predictability — having codified and published guidelines and regulations; maintaining procedural fairness, including adhering to strict timelines and protecting commercially-sensitive information; and disclosing policy actions and decisions
- regulatory proportionality — restrictions (or conditions) on investment should not be greater than needed to achieve their goals (e.g. protect national security) and should be avoided when other measures are better-suited to addressing concerns
- accountability — including parliamentary oversight, judicial review, regulatory impact statements, and requiring important decisions be taken at high government levels.

Source: OECD (2009, pp. 3–4).

The negative nature of the ‘national interest’ test should be retained

Two of the main elements of the policy framework are the ‘negative’ national interest test and the Treasurer as the decision maker.

The national interest test, including its negative framing, is important for several reasons.

- It places the onus of proof on the Government to allow all foreign investment *unless* it can determine that a proposed investment is against the national interest. This is a fairly high bar and few investment applications are blocked outright.
- It gives Treasurers discretion to define the national interest as they see fit, in a manner that changes over time. This broad discretion has the advantage of allowing governments to respond quickly to new concerns that are likely to affect the national interest, as well as to avoid blocking investments on grounds that were once relevant, but no longer are.
- It allows the Treasurer to weigh up the potential benefits of an investment proposal, not just the potential costs.

Regardless of the test, getting the balance right between economic benefits and national security risks is far from straightforward. Some commentators argue that national security decisions should be made by the National Security Committee of Cabinet (NSC), rather than the Treasurer. However, while the risks associated with foreign investment are mostly not economic, the benefits are, which is a strong reason to retain the Treasurer (who sits on the NSC) as decision maker. Indeed, the new national security test will be decided by the Treasurer.

Too many conditions are being imposed

The use of conditional approvals by Treasury, the ATO and FIRB is relatively common and has been growing in recent years. In 2017-18, FIRB applied conditions to 44 per cent of approved applications, which represented 75 per cent of the value of approved applications.

While conditions may be one way to address potential risks or policy concerns without having to block an investment outright, the risks from foreign investment can also be addressed through national regulations, such as tax and competition law, environmental regulation and so forth. Indeed, the effectiveness of conditions in mitigating risk is limited, compared with sound regulation:

- While conditions can be imposed at the point of investment approval, national security, taxation and competition risks evolve, so the conditions become less effective over time.
- Normally, only foreign acquisitions with values above specific thresholds are subject to FIRB screening; smaller investments are not reviewable by FIRB.
- Conditions that duplicate existing legal requirements on businesses operating in Australia add to the regulatory burden without delivering additional benefits. For example, ‘standard tax conditions’ in response to the risk of multinational tax avoidance mostly require companies to comply with Australian tax laws.

The growing use of conditional approvals means there is an ongoing need for compliance monitoring to ensure that the conditions have been met. This is changing and expanding Treasury and FIRB’s role from that of a gatekeeper to also being that of a regulator.

Treasury is not well-suited to being a regulator. Up until recently, it lacked the graduated enforcement toolkit available to other regulators. Such a toolkit would be needed to ensure proportionate responses to breaches of conditions. While the Australian Government has recently announced that Treasury’s compliance and enforcement powers will be expanded, it remains to be seen how these will work in practice. More broadly, consideration should be given to the most suitable institutional design to support both decision-making on foreign investment applications and, if conditions are imposed, subsequent monitoring and enforcement of compliance.

Transparency and certainty could be improved

Two key areas of FIRB and Treasury’s regulatory practice could be improved. There should be greater clarity of the reasons for decisions (enabling lawyers to better advise their clients) and set time periods for decision making (reducing uncertainty for potential investors).

Transparency of decision making is low. While it is understandable that the Government does not comment on national security matters, its treatment of investment applications (even those with no national security dimensions) is unusually secretive. When a foreign investment proposal is blocked, the action of the Treasurer is gazetted, but no reasons are provided for the decision. Sometimes, when an investment proposal has a high profile, the

Treasurer sometimes issues a press release stating the decision and the reasons for it. If the Government identifies potential problems with an application which encourages the investor to withdraw their application, there is no public communication at all.

Routine publication of reasons for decisions would improve investor certainty. Similar views were expressed by the 2016 Senate Economic References Committee inquiry into the foreign investment review framework, which recommended that FIRB ‘publish the Treasurer’s rationale behind both positive and negative decisions regarding foreign investment, in order to inform the public and to instil public and investor confidence in the review process’ (SERC 2016, p. ix). This recommendation was not adopted.

On timeliness, FIRB has a statutory timeframe of 30 days in which to respond to applications. If a decision has not been made within 30 days (and the applicant has not been advised), the application is deemed to be approved. The Treasurer can also extend the examination period for up to 90 days. In March 2020, the Treasurer announced changes to the foreign investment framework which would temporarily increase processing times from 30 days up to 6 months (box 1 above).

In practice, the median application processing time by the FIRB was 45 days in 2018-19. For non-sensitive commercial applications processed by the ATO it was 23 days and for ATO residential applications it was nine days.

The statutory timeframes provide some assurance to investors that decisions will be timely and predictable, but there is scope to provide more certainty to investors. Inevitably, there will be variations on the timeliness of some decisions, given the diversity and potential complexity of investment proposals. Nonetheless, FIRB could provide more detailed reporting on the timeliness of decisions to improve transparency. The Commission also heard from stakeholders that advance warning when standard timelines will not be met would allow them to manage acquisitions or pursue alternatives more efficiently.

Aligning fees with the cost of administration

The Australian Government introduced fees for foreign investment applications in December 2015. The fees vary according to the type of investment and its value.

- Fees for residential real estate applications range from \$5700 (for an acquisition of \$1 million or less) to over \$100 000 (for an acquisition over \$9 million).
- Application fees for commercial land acquisitions and business investment range from \$2000 (for an acquisition of \$10 million or less) to about \$100 000 (for an acquisition over \$1 billion).
- Application fees for agricultural land acquisitions range from \$2000 (for an acquisition of \$2 million or less) to about \$100 000 (for an acquisition over \$10 million).

These are taxes, not a fee for service. They are set at levels that are out of proportion with the cost of delivering the regulatory regime. In 2017-18, the government collected

\$114 million in fee revenue, while the operational costs of FIRB and its secretariats in the Treasury and the ATO totalled only \$14.7 million.

They are also likely to be fairly inefficient taxes. Taxing foreign businesses reduces foreign investment, leading to lower Australian wages and incomes. The much higher fees on (small) agricultural investment applications than on other business applications have the potential to detract from growth in regional communities.

The Commission, in its *Regulation of Australian Agriculture* inquiry, recommended that the Australian Government should set application fees for foreign investment proposals at the level that recovers the costs of administration, and closely monitor the fees so that there is no over- or under-recovery of costs. The case for reform has not changed since that inquiry, and if anything, it has strengthened.

1 The trends and drivers of foreign investment

Key points

- Australia has long attracted foreign investment. Foreigners seek to invest in Australia because of our fast growing, well-educated population, rich natural resource base, and a stable cultural, legal and macroeconomic environment.
 - Australia hosts \$3.5 trillion worth of foreign investment, while Australians have \$2.5 trillion invested overseas. These foreign investment figures include debt, derivatives and equity investment.
 - To put these estimates in context, the value of physical assets in the Australian economy (excluding housing) is estimated to be about \$6 trillion, and aggregate household net wealth is about \$10.5 trillion.
- Foreign direct investment (FDI) is the portion of these holdings that is accompanied by a degree of foreign control over the domestic operation. Australia's inward stock of FDI totalled \$967.5 billion (52 per cent of gross domestic product or GDP) at December 2018, following strong growth since 2001.
 - The strong growth in FDI into Australia contrasts with flatter global trends since the financial crisis.
- While Australia is a growing net debtor to the world due to wholesale loans to the banking sector (which are largely used for residential mortgages), Australia has become a net equity investor in recent years, due to portfolio investment abroad by superannuation funds.
 - Australia's net direct equity investment now stands at about \$250 billion (6 per cent of GDP).
- The largest sources of FDI into Australia remain the United States, Japan and the United Kingdom.
 - Chinese investors have significantly increased their holdings in the past decade, although identifying the precise value is difficult. Data suggest that flows into Australia for which the ultimate beneficial owner is from China are about three times as high as those for which they are the immediate owner, as funds flow through corporate structures in third countries.

As a small, open economy, Australia has a long history of both attracting foreign investment and investing overseas, including through the superannuation system. This chapter explores the recent trends and drivers of foreign investment, providing:

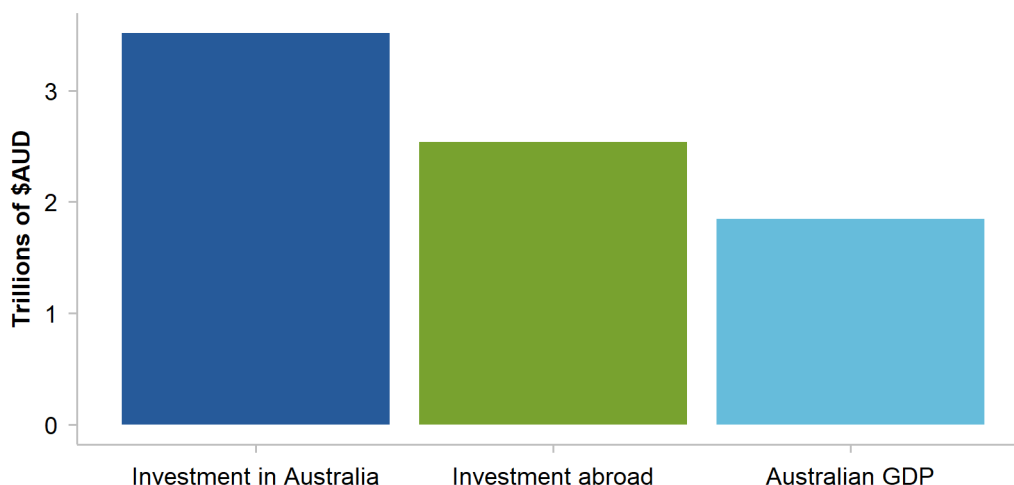
- a stocktake of current foreign investment levels and definitions of the types of foreign investment (section 1.1)
- the drivers of foreign investment (section 1.2)
- changes in Australia's net investment position (section 1.3)

-
- trends in inward foreign direct investment (section 1.4)
 - trends in outward foreign direct investment (section 1.5).

1.1 What is foreign investment?

Australia is host to \$3.5 trillion of foreign investment, while Australian investors have \$2.5 trillion worth of investment abroad (figure 1.1). To put these estimates in context, Australia's gross domestic product (GDP) in 2017-18 was \$1.8 trillion, the value of physical assets in the Australian economy (excluding housing) is estimated to be about \$6 trillion, and aggregate household net wealth is about \$10.5 trillion (ABS 2018, 2019a).

Figure 1.1 Australia hosts large amounts of foreign investment
Foreign investment in Australia and Australian investment abroad (at December 2018), against Australian GDP for 2017-18



Sources: ABS, *International Investment Position, Australia: Supplementary Statistics, 2018*, cat. no. 5352.0 (tables 2 and 5) and *Australian National Accounts: National Income, Expenditure and Product, Dec 2018*, cat. no. 5206.0 (table 34).

Stocks, flows and the direction of foreign investment

Official foreign investment statistics are compiled using a 'directional principle' (box 1.1). Investment by foreigners in Australia is referred to as 'inward investment' for levels of investment (stocks), or as an 'inflow' if it is moving across the border (flows) — these represent the net activities (investment less divestment) of foreign investors in Australia over a given period, usually one year. Similarly, investment by Australians abroad is generally

referred to as ‘outward investment’ (for stocks) or ‘outflows’ of investment (for flows) — these are the net activities of Australians investing abroad.

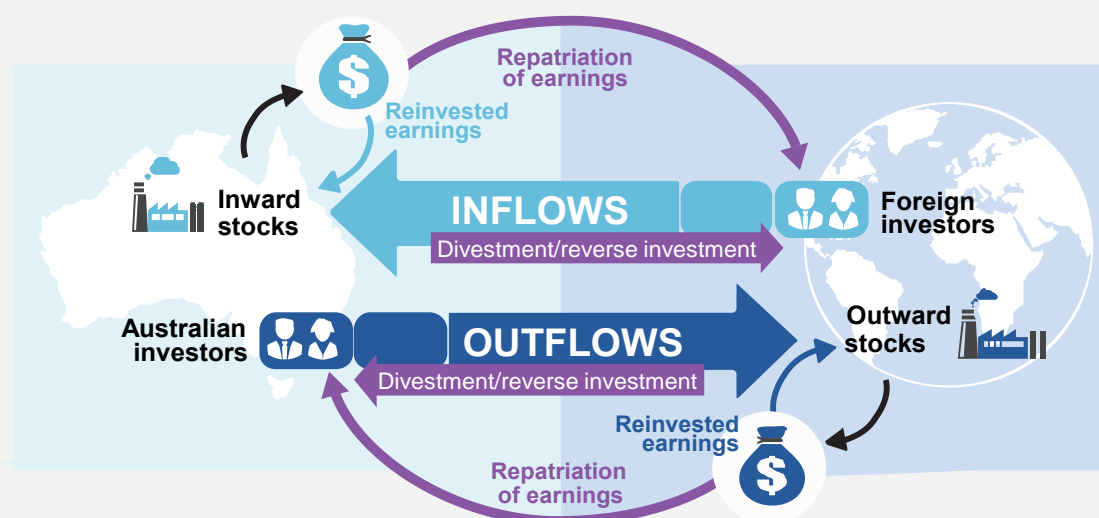
Box 1.1 The directional principle

The ‘directional principle’ determines how flows, levels and income are recorded as they cross the Australian border (figure below).

Inflows, outflows and inward and outward investment are recorded independently of each other.

- Inward stocks reflect the level of investment from foreign investors at a point in time while inflows reflect the net changes in these stocks (investment less divestment) — this is the activity of foreign investors in Australia over a period, usually one year.
- Australian investors operating abroad are reflected in the outward investment levels, and in outflows that record the net change in domestic investment leaving Australia.

Both inflows and outflows are measured in net terms and need not be positive. For example, if a foreign company sells an Australian subsidiary to an Australian buyer, this will be recorded as a negative inflow. Some earnings from investments are repatriated to the source country and recorded as income credits/debits, while reinvested earnings are recorded as increases in investment stocks. Together, these measures help give a picture of how foreign investment funds flow across Australian borders.



Source: ABS (2019b, sec. explanatory notes).

Types of foreign investment

Most foreign investment falls into two categories (figure 1.2):

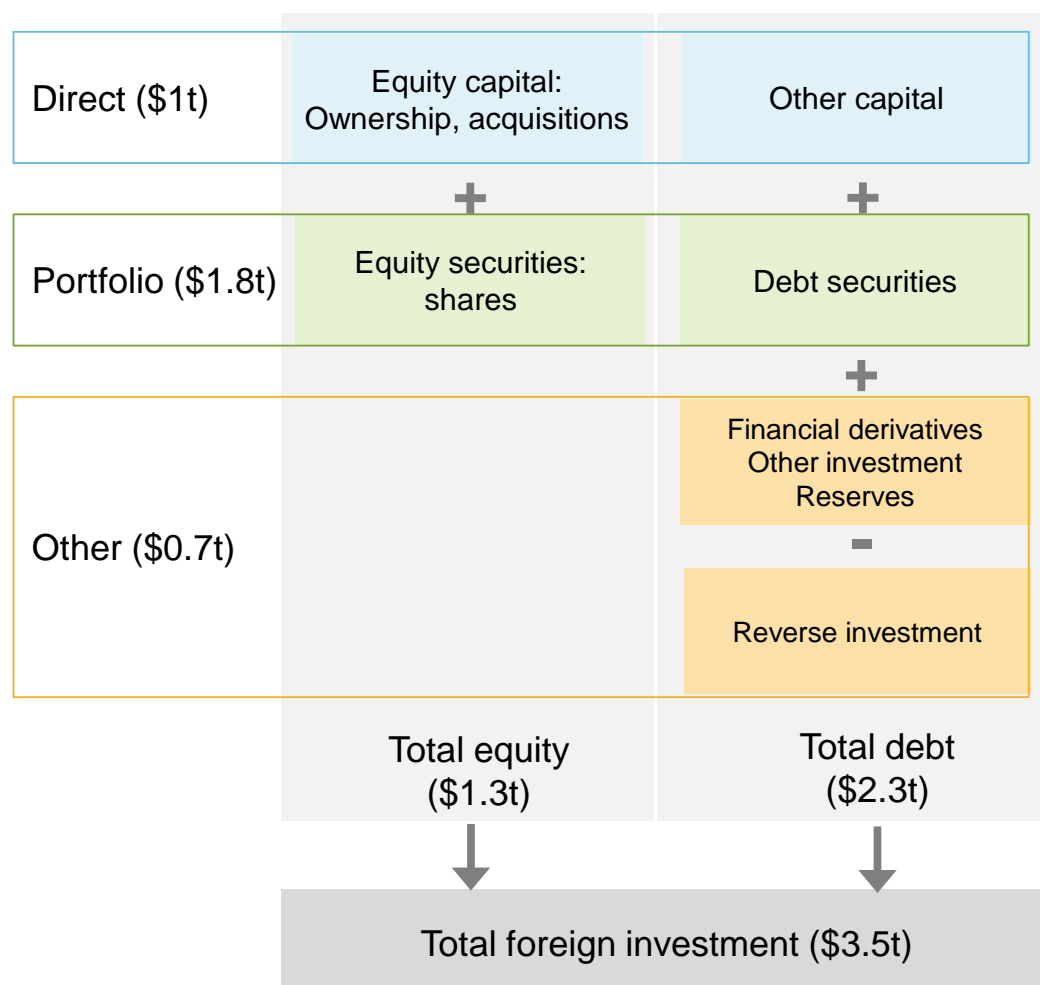
- foreign portfolio investment — the purchase of equity (such as shares) and debt securities (such as bonds), where the foreign investor does not have any controlling interest or influence in the asset or company
- foreign direct investment (FDI) — investment in an enterprise or asset where the foreign investor has control or a significant degree of influence over management. Generally,

investment is considered to be ‘direct’ when an investor has 10 per cent or more of the voting power in the company. Direct debt investment is debt between related parties.³

Other more minor forms of investment include derivative instruments and reserve assets.

Figure 1.2 The different kinds of foreign investment

By Australian inward foreign investment stocks (\$ trillions), at December 2018^a



^a The sum of total equity and debt equals total foreign investment. Discrepancies due to rounding.

Source: ABS, *International Investment Position, Australia: Supplementary Statistics, 2018*, cat. no. 5352.0 (table 2).

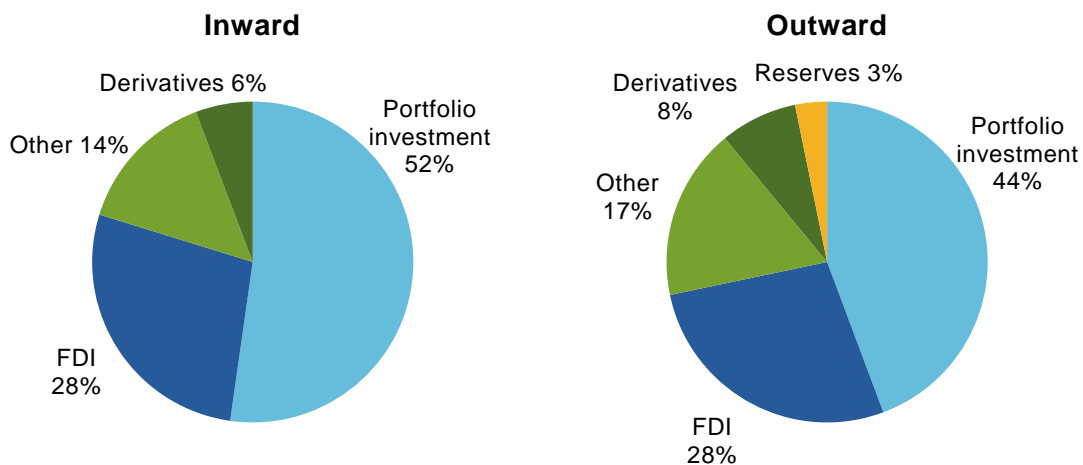
In Australia, portfolio investment is the largest proportion of both inward and outward foreign investment, close to double the share of FDI (figure 1.3). Portfolio investment can

³ This definition of FDI is in line with the International Monetary Fund’s (IMF’s) *Balance of Payments and International Investment Position Manual* (BPM6), which the Australian Bureau of Statistics follows in most of its national accounts and international investment statistics (ABS 1998; IMF 2009). The definition of FDI used by the IMF is based on the Organisation for Economic Cooperation and Development’s (OECD’s) *Benchmark Definition of Foreign Direct Investment* (2008).

be highly liquid and transient, although Australia’s robust economic institutions and management of foreign exchange and duration risk by banks has allowed generally stable and reliable access to portfolio investment.

However, FDI is the subject of more policy attention (discussed in chapter 3). There is a level of community interest and, at times, concern about the direct control of assets or businesses by foreigners. For these reasons, this report is largely focused on the FDI component of Australia’s inward foreign investment.

Figure 1.3 Portfolio investment dominates
Proportions of foreign investment stocks, at December 2018



Source: ABS, *International Investment Position, Australia: Supplementary Statistics, 2018*, cat. no. 5352.0 (tables 2 and 5).

1.2 The drivers of foreign investment

There are many drivers of foreign investment flows across the globe, from individual markets, to country-specific macroeconomic conditions, to global conditions.

- **Markets** — businesses investing abroad seek access to new markets where they have a competitive advantage. This is related to the size of the host country’s economy and potential for economic growth.
- **Assets** — businesses seek to acquire new technologies, managerial skills or access to a labour force that is complementary to their existing operations.
- **Natural resources** — countries with endowments of natural resources require significant investment to exploit it fully, which often exceeds what can be financed by domestic savings.
- **Efficiency seeking** — labour costs and productivity levels are factors for firms choosing to invest abroad.

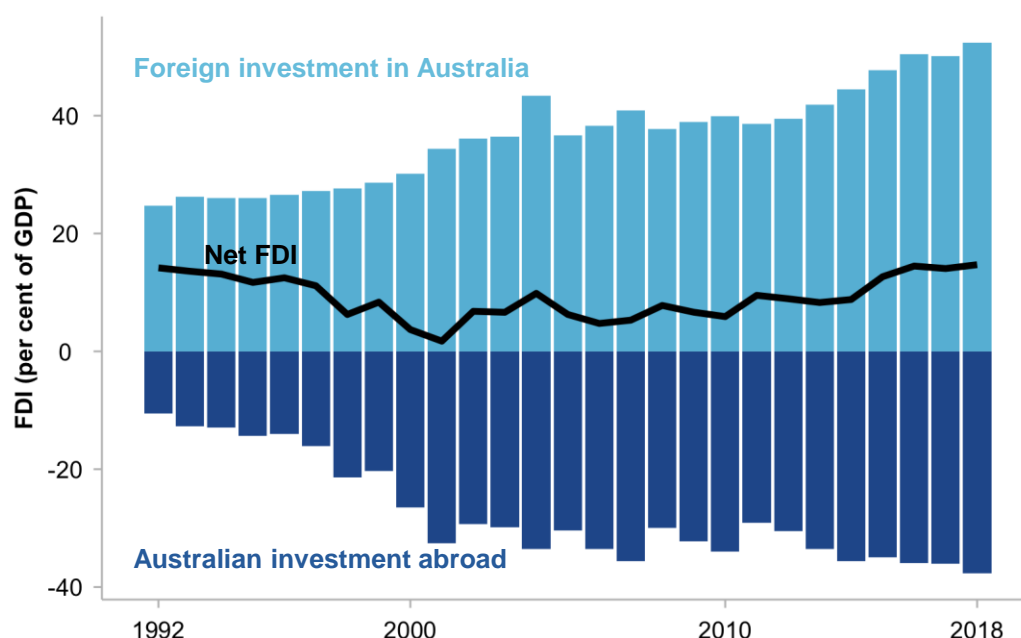
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- Institutions — the quality of institutions (e.g. enforcement of property rights, risk of appropriation), the stability of government and the ease of doing business are all factors that affect FDI.
 - Macroeconomic stability — stable inflation rates, exchange rates and other macroeconomic indicators add to the attractiveness of a country for FDI. Large and unpredictable fluctuations of these factors add to investment uncertainty (Carril-Caccia and Pavlova 2018).

1.3 What is Australia's net investment position?

For foreign investment as a whole — including direct, portfolio and other investment — Australia has long had more inward investment than Australian investors have had abroad. Ongoing positive net foreign investment has allowed Australia to sustain an investment level that is higher than domestic savings (chapter 3).

Similarly, for FDI stocks, Australia has traditionally had more inward FDI than Australian FDI abroad. In the past two decades, Australia's net inward FDI has been growing, increasing to 15 per cent of GDP in 2018, from a low of 2 per cent in 2001. This increase was driven by the marked increase in inward FDI, rather than large decreases in outward FDI (figure 1.4).

Figure 1.4 Australia hosts more FDI than Australians invest abroad
Net FDI stocks relative to GDP, 1992–2018^a



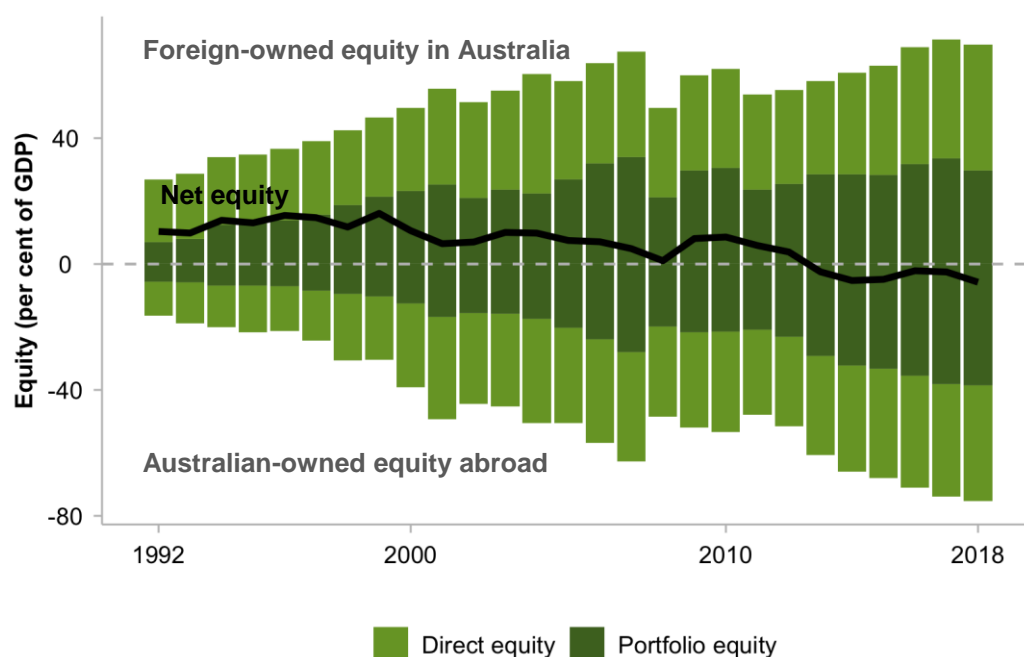
^a The significant transactions in December 2004 and June 2005 were due to a large corporate group restructure, with the eventual transfer of its Australian subsidiaries moving offshore (ABS 2019b, sec. explanatory notes).

Sources: ABS, *International Investment Position, Australia: Supplementary Statistics*, cat. no. 5352.0 (various years) and Commission estimates.

Australia's net equity position has changed

Australia is a growing net debtor to the world due to wholesale loans to Australia's banking sector, which in turn are largely used for residential mortgages. But in recent years, Australian ownership of equity abroad has grown rapidly (figure 1.5) and Australians are now net owners of foreign businesses, with net equity investment standing at about 6 per cent of GDP (\$250 billion). This change largely reflects the sizable offshore investments of the superannuation sector (Debelle 2019). It is also partially attributable to foreign exchange valuation effects, where depreciation of the Australian dollar adds to the value of foreign equity investments held by Australians.

Figure 1.5 Australians now own more equity abroad
Net foreign equity position relative to GDP, 1992–2018^a



^a Total Australian equity owned by foreigners less total foreign equity owned by Australians. Foreign direct and portfolio investment is the sum of direct and portfolio debt and equity. This chart only includes the equity components.

Sources: ABS, *International Investment Position, Australia: Supplementary Statistics*, cat. no. 5352.0 (various years) and Commission estimates.

1.4 Inward FDI — recent trends

Overall, Australia's inward FDI stocks totalled \$967.5 billion (52 per cent of GDP) at December 2018, with a marked increase in both the nominal value and share of GDP since 2001 (figure 1.4 above). The driver of this growth has been steadily increasing net inflows of FDI (with more FDI coming in than being repatriated to, or divested by, foreigners). The size of these inflows has particularly increased since 2013, resulting in a sharp increase in inward FDI stocks relative to GDP.

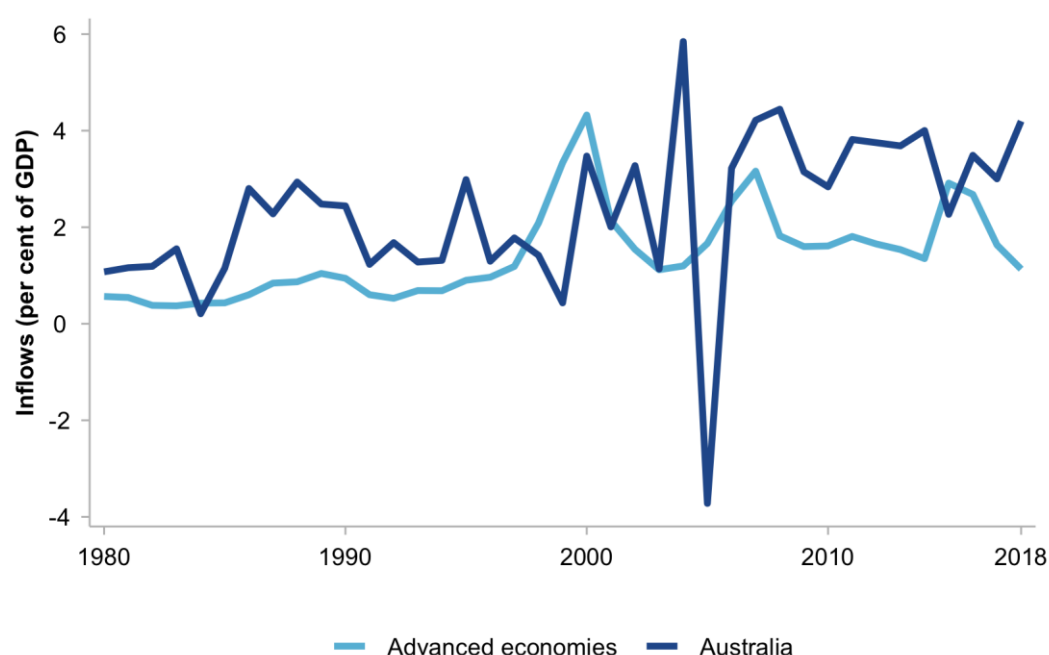
Global standing and trends in FDI

Australia's level of inward FDI is also affected by global trends and drivers. Since the 2008 financial crisis, FDI inflows have stagnated around the developed world. This reflects several factors, including geographic changes in the weight of economic activity (Chinese

economic transactions are increasingly China-focused), the move towards ‘asset light’ services industries, increased global uncertainty, and recent tax policy changes favouring repatriation of US multinational profits.

However, Australia has largely bucked this advanced economy trend, particularly in recent years, with strong inward FDI flows (figure 1.6). This partially reflects Australia’s foreign investment attractiveness, but also reflects large-scale foreign investment in particular sectors such as mining and finance. Australia remains an attractive host for FDI, with the 14th largest inward FDI stocks in 2018, or the 19th largest relative to GDP — just above the Organisation for Economic Cooperation and Development (OECD) member country average (figure 1.7).

Figure 1.6 Australia bucks the global trend
Inflows of FDI relative to GDP, 1980–2018^a



^a The significant transactions in December 2004 and June 2005 were due to a large corporate group restructure, with the eventual transfer of its Australian subsidiaries moving offshore. ‘Advanced economies’ refer to the World Bank’s standard of classification.

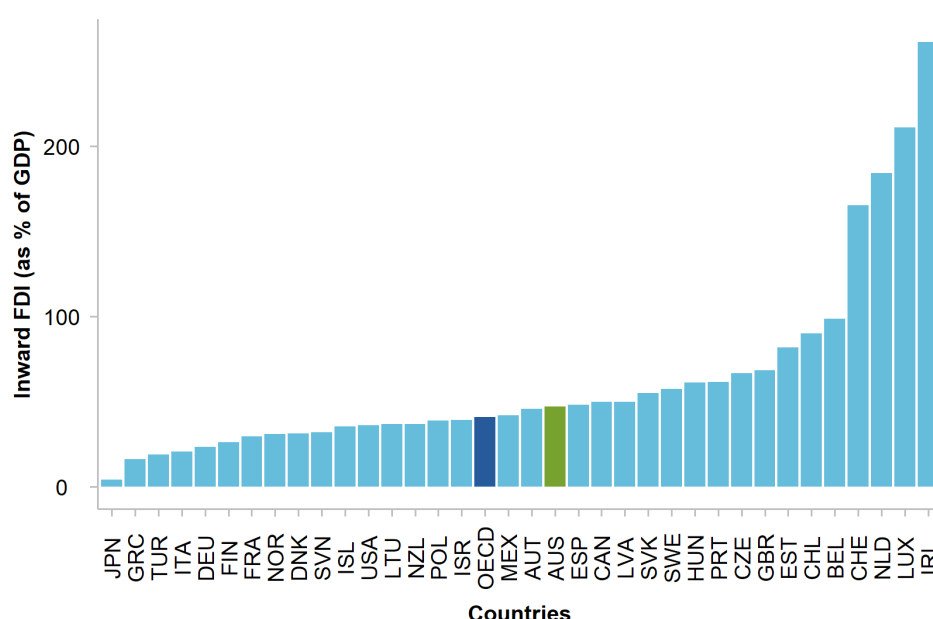
Source: UNCTAD (2020).

More recently, global FDI flows declined for the third consecutive year in 2018, falling by 13 per cent to US\$1.3 trillion. This decline was mostly for investment into advanced economies, as emerging and developing economies saw steady inflows of 2 per cent, similar to recent years. Although these short-term flows appear volatile and give the impression that there are large shifts of capital across the globe, this can be misleading. The volatility in the

data is often due to one off policy changes that cause a restructuring of finances or restructuring of large multinational companies. For example, the 2018 decline in global inflows has largely been attributed to tax reform in the United States (the 2017 Tax Cuts and Jobs Act), which eliminated taxes on repatriated earnings by US multinationals. This encouraged a large repatriation of earnings. The International Monetary Fund's World Economic Outlook said:

... the sharp decline in global FDI flows in 2018 seems to be explained almost entirely by multinational corporations' financial operations ... These developments further underscore how FDI transactions and positions recorded in the balance of payments are often unrelated to greenfield investment or mergers and acquisitions, but rather reflect tax and regulatory optimization strategies by large multinational corporations (2019a, p. 40).

Figure 1.7 Australia is slightly above average in attracting FDI
Inward FDI stocks relative to GDP, OECD countries, 2018



Source: OECD (2020).

In addition to shortterm movements, there is a longer-term trend of declining FDI flows (as a share of GDP). The United Nations Conference on Trade and Development (UNCTAD) stated in its 2019 World Investment Report that:

The underlying FDI trend has shown anaemic growth since 2008. FDI net of one-off factors such as tax reforms, megadeals and volatile financial flows has averaged only 1 per cent growth per year for a decade, compared with 8 per cent in 2000–2007, and more than 20 per cent before 2000. Explanations include declining rates of return on FDI, increasingly asset-light forms of investment and a less favourable investment policy climate (2019, p. xi).

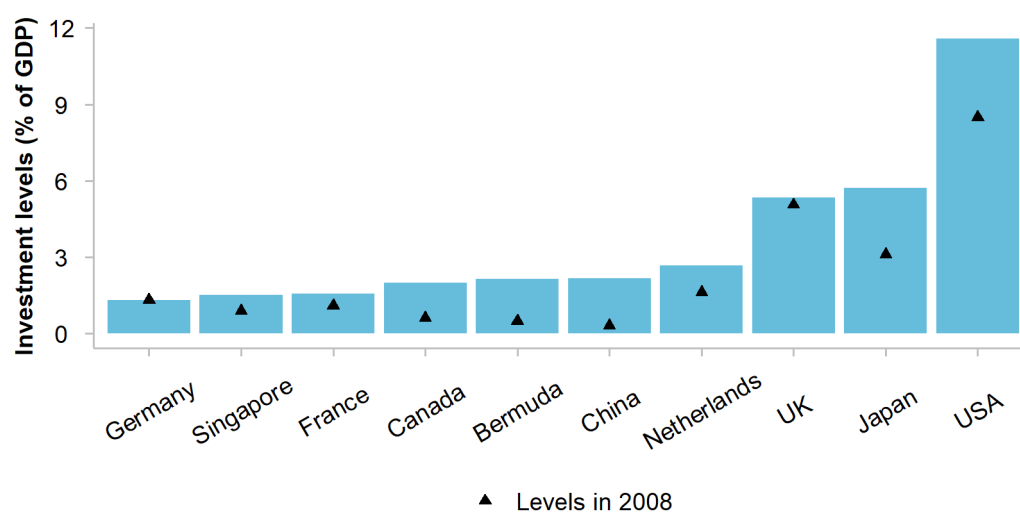
Where does Australia's FDI come from?

Australia's largest source of FDI at December 2018 was the United States, with inward levels of \$214 billion (11 per cent of GDP), or 22 per cent of total FDI stocks in Australia (figure 1.8). Japan (\$106 billion), the United Kingdom (\$99 billion), the Netherlands (\$49 billion) and China (\$40 billion) also hold significant investments in Australia.

The United States and Japan have been increasing their investment in Australia over the past decade, with the United Kingdom having remained steady. In recent years, a prominent trend has been China's increased role in global investment. Chinese outward investment has grown in the past decade from low levels in 2008 to become Australia's 5th largest FDI investor, with 4 per cent of total FDI stocks at the end of 2018.

Figure 1.8 **Australia's closest economic partners are still Australia's biggest investors**

Top 10 sources of inward FDI stocks, relative to GDP, 2008 and 2018^a



^a Columns are 2018 levels, while legend shows the level of these countries in 2008.

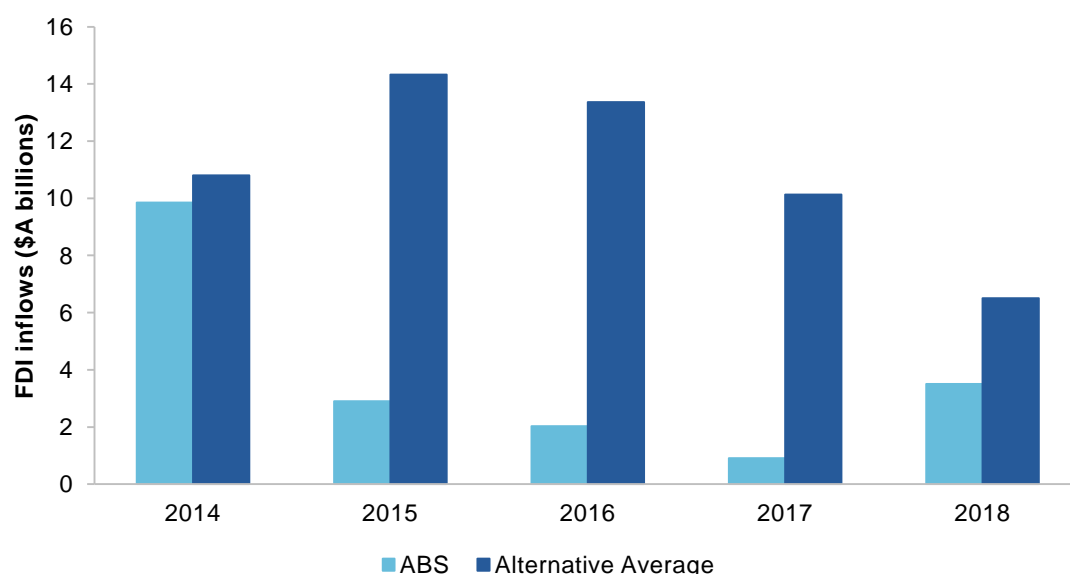
Source: ABS, *International Investment Position, Australia: Supplementary Statistics, 2018*, cat. no. 5352.0 (table 2).

A limitation of foreign investment statistics, as collected by national statistical offices such as the Australian Bureau of Statistics (ABS), is that the country of origin is identified based on the 'immediate owner' rather than the 'ultimate beneficial owner'.⁴ Where investment flows through corporate structures in different countries, the two ownership concepts give different outcomes. However, there have been other attempts to identify the extent of

⁴ The ABS has indicated they will begin collecting data identified by ultimate beneficial owner, for publication alongside data collected on an immediate owner basis in future years.

investment into Australia, particularly focused on those that have a Chinese ultimate beneficial owner (appendix B). While estimates vary in both methodology and what they measure, they suggest that inflows into Australia with ultimate beneficial ownership by an investor in China could be averaging about three times as high over recent years as inflows from China measured by immediate ownership (figure 1.9).

Figure 1.9 Data differ greatly on Chinese ‘immediate’ and ‘ultimate’ beneficial owner of FDI
Chinese inward FDI from the ABS and an average of other sources, 2014–2018^a



^a Averages taken from all sources except 2018, which only includes ANU and KPMG/Uni Sydney. The ABS records net inflows, while the alternatives record different measurements of gross inflows.

Sources: ABS, *International Investment Position, Australia: Supplementary Statistics, 2018*, cat. no. 5352.0 (table 2); AEI/HE (2019); ANU (2018); and USyd/KPMG (2019).

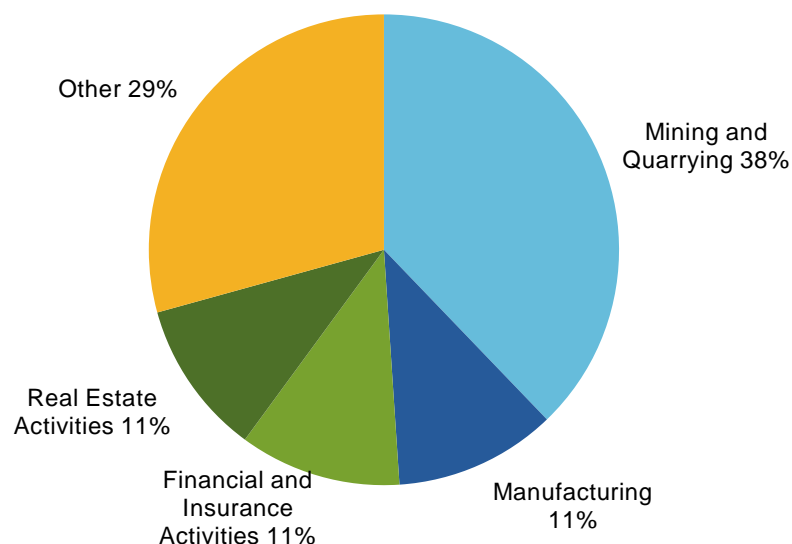
What sectors attract FDI?

Foreign investors favour certain sectors of the Australian economy more than others (figure 1.10). The largest stock of inward FDI in 2018 was in mining (\$365 billion, or 38 per cent of the economy-wide total), followed by manufacturing, real estate and financial services, which each accounted for about \$100 billion (11 per cent).

In the past decade, the real estate and mining and quarrying sectors have both increased as a share of total FDI stocks. However, FDI inflows to the mining and quarrying sector have recently slowed, from a peak inflow of \$55 billion in 2014 to only \$17 billion in 2018.

Figure 1.10 Mining takes the cake

Inward FDI stocks, by sector, as a proportion of total FDI, at December 2018



Source: ABS, *International Investment Position, Australia: Supplementary Statistics, 2018*, cat. no. 5352.0 (table 15).

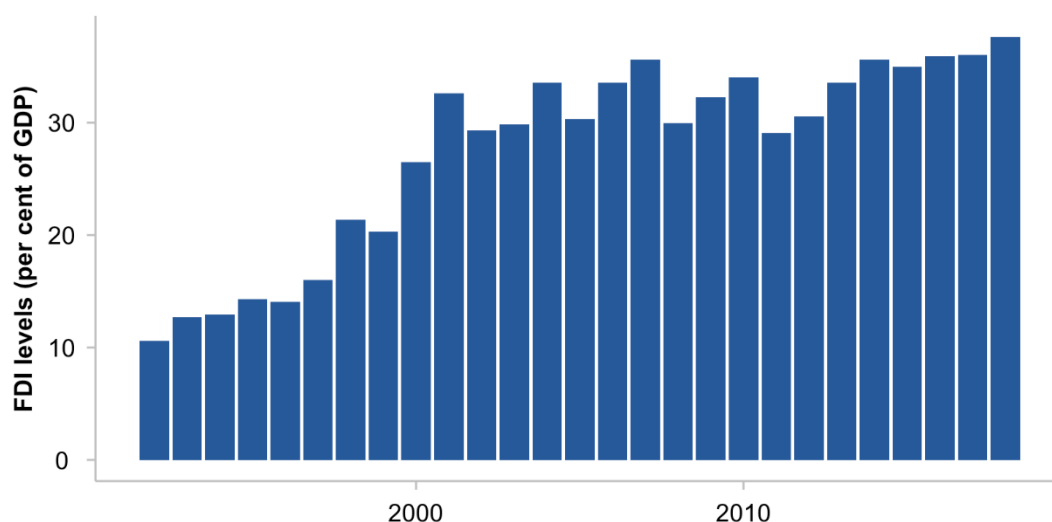
1.5 Outward FDI — recent trends

Australian investors also own and control a substantial amount of assets and enterprises abroad. At the end of 2018, Australia's outward FDI stocks had reached \$696 billion, equivalent to 38 per cent of Australia's GDP (figure 1.11). Globally, Australia is the 17th largest foreign direct investor in the world (DFAT 2019).

Prior to 2001, Australia's outward FDI stocks had grown rapidly, with net outflows of FDI at about 30 per cent of GDP in 2001. However, FDI stocks have since grown only roughly in line with the economy, with close to zero net outflows in 2017 (and even a brief net divestment of outward FDI in 2015). Like inward FDI, this change has been driven by global trends, as well as by investment in specific sectors such as mining.

Figure 1.11 **Australian FDI abroad has been largely steady since 2001 relative to GDP**

Outward FDI stocks, 1992–2018

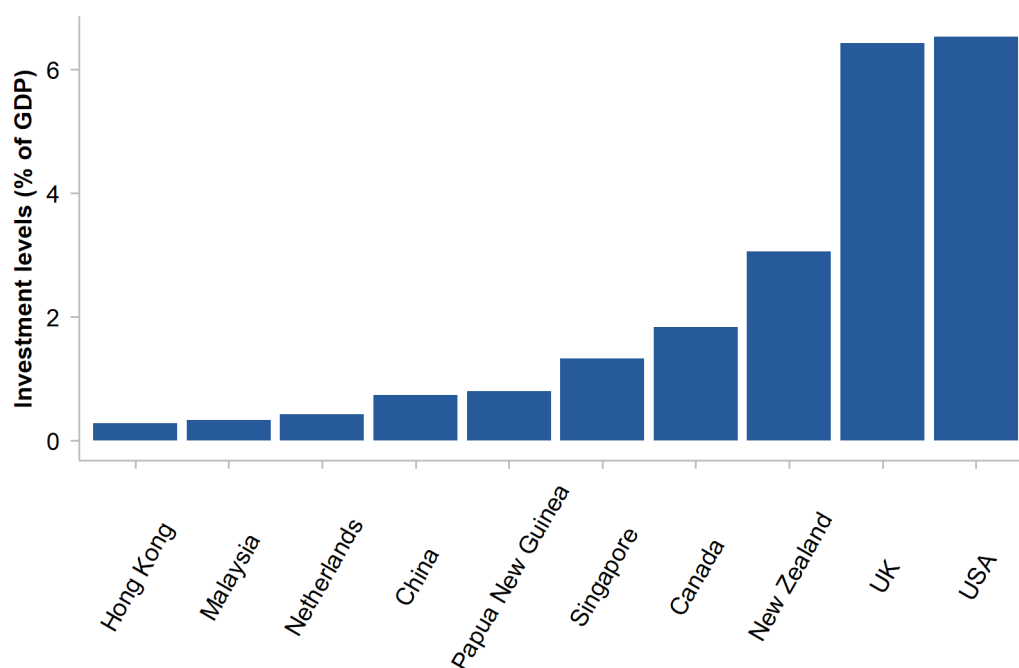


Source: ABS, *International Investment Position, Australia: Supplementary Statistics*, cat. no. 5352.0 (various years).

Where do Australians invest abroad?

Similar to inward FDI, historical economic trading partners are where Australian investors choose to put the largest amounts of foreign investment. The United States and United Kingdom are the largest recipients of Australian FDI, with \$121 billion and \$119 billion, respectively (figure 1.12). This is followed by New Zealand (\$56 billion), Canada (\$34 billion) and Singapore (\$24 billion).

Figure 1.12 Top 10 Australian investment destinations
Outward FDI by destination, relative to Australian GDP, at December 2018

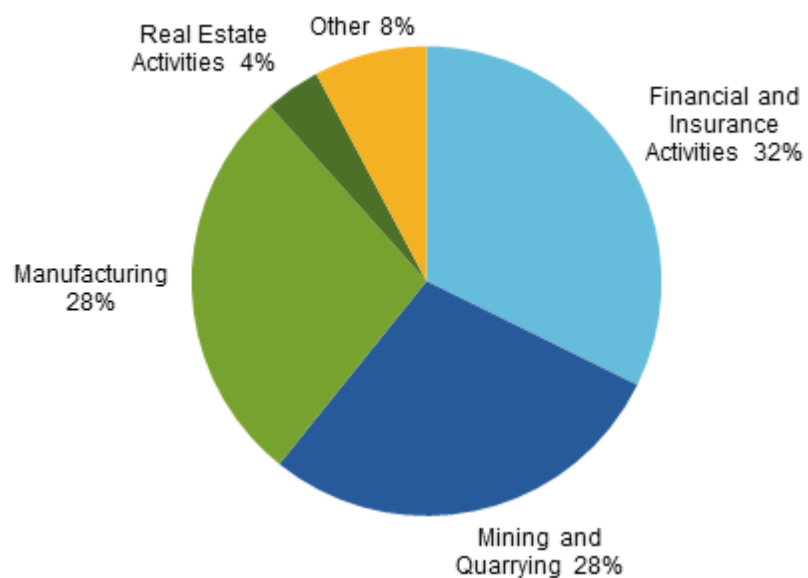


Source: ABS, *International Investment Position, Australia: Supplementary Statistics, 2018*, cat. no. 5352.0 (table 5).

What sectors do Australians invest in abroad?

Australian FDI abroad is concentrated in three sectors, with financial and insurance services (32 per cent), mining (28 per cent) and manufacturing (28 per cent) making up the overwhelming majority of total outward FDI (figure 1.13). These shares have remained relatively stable over time.

Figure 1.13 Australians invest in mining, manufacturing and finance
Outward FDI stocks, by sector, as a proportion of total FDI, at December 2018



Source: ABS, *International Investment Position, Australia: Supplementary Statistics, 2018*, cat. no. 5352.0 (table 17).

2 Current policy settings

Key points

- Australian Government policy is to screen foreign investment proposals over certain monetary thresholds. As a part of this screening, the Treasurer (advised by the Foreign Investment Review Board or FIRB) may decide that a foreign investment proposal would be contrary to Australia's 'national interest' and block it, or allow it subject to conditions.
 - The 'national interest' is not defined in legislation, but the current policy outlines five factors that are typically considered: national security; competition; other Australian Government policies (such as tax); the impact on the economy and community; and the character of the investor.
- Australia's broad screening regime and relatively low thresholds for screening make Australia's foreign investment policy one of the more restrictive among advanced economies. While international comparisons can be imprecise, there is some evidence that differences in foreign investment policy can explain some of the differences in foreign investment across countries.
- Australia approves the vast majority of foreign investment applications. Between 2015 and 2018 only 10 out of more than 100 000 applications were rejected. On average, about 5 per cent of applications are withdrawn prior to a decision, which may be due to business decisions or to pre-empt a likely rejection.
 - Residential real estate makes up the majority of applications — accounting for about 90 per cent of applications in 2017-18.
 - On the one hand, the low rate of rejections may mean that Australia's screening regime is less restrictive than it appears. On the other hand, the presence of a screening regime may itself discourage some foreign investment, which would not be observable through the application/rejection numbers (although it can be modelled, chapter 3 and appendix A).
- Conditions are commonly attached to foreign investment approvals. In 2017-18, FIRB applied conditions to 43 per cent of approved applications, which represented 75 per cent of the value of approved applications.
- The Australian Government charges fees for foreign investment applications which vary according to the type of investment and its value. The Australian Government also charges a 'vacancy fee' for foreign owners of real estate. In addition, state governments charge stamp duty surcharges on foreign purchasers of property, while three states and the ACT charge higher rates of land tax on absentee owners (whether foreign or domestic). These fees and charges have all been introduced in the past five years.

2.1 Outline of Australia's foreign investment framework

Under current policy settings, all foreign investment proposals that exceed prescribed thresholds⁵ are subject to screening (table 2.1). In response to the COVID-19 pandemic, the Government temporarily reduced the monetary thresholds to \$0 (box 2.1). If the Treasurer forms the view that the foreign investment would be contrary to Australia's national interest, they can:

- make an order to prohibit the investment going ahead
- allow the investment but impose conditions
- order disposal of the investment if it has already gone ahead.

If the Treasurer takes no action applications are deemed approved after statutory time periods.

In June 2020, the Government announced it would be making significant changes to the foreign investment policy settings (box 2.2)⁶.

Table 2.1 Foreign investment review thresholds

	Threshold — partner countries subject to higher threshold ^a	Threshold — other countries
	\$ million	\$ million
Residential real estate or vacant land	0	0
Developed commercial real estate	1 192	275
Business acquisitions in non-sensitive sectors	1 192	275
Business acquisitions in sensitive sectors ^b	275	275
Agricultural land	1 192 ^c	15 ^d
Agribusinesses	1 192	58
Foreign government investors: all direct investments, new business proposals and interests in land	0	0

^a Currently applies to investors from Canada, Chile, China, Japan, Mexico, New Zealand, Singapore, South Korea, the United States and Vietnam, and any country for which the TPP-11 subsequently comes into force. ^b Sensitive sectors are media, telecommunications, transport, defence and military-related industries, encryption and securities technologies and communication systems, and the extraction of uranium or plutonium or the operation of nuclear facilities. ^c For Chile, New Zealand and the United States. ^d For Thailand \$50 million.

Source: FIRB (2020a).

The Treasury, the Foreign Investment Review Board (FIRB) and the Australian Taxation Office (ATO) are responsible for screening foreign investment proposals in line with

⁵ Investments into Australia also have to meet a 'change of control' test, which is generally met if the investor acquires an interest of 20 per cent or more.

⁶ At the time of publication these changes had not been legislated.

Australia's foreign investment review framework (Australia's Foreign Investment Policy, the *Foreign Acquisitions and Takeovers Act 1975* (FATA) and associated regulations). FIRB is a non-statutory body in the Treasury portfolio, responsible for examining foreign investment proposals that fall within the foreign investment framework, and for advising the Treasurer and the Government on foreign investment policy and administration.

Box 2.1 Recent changes to foreign investment policy

On 29 March 2020, the Treasurer announced that the Government would be screening all foreign investment into Australia as a temporary measure for the duration of the COVID-19 crisis. To allow time to screen applications, FIRB will extend the timeframes for screening from 30 days up to 6 months but will prioritise applications for investments that 'protect and support Australian businesses and jobs'.

The Treasurer said 'these measures are necessary to safeguard the national interest as the coronavirus outbreak puts intense pressure on the Australian economy and Australian businesses'.

In June 2020, the Australian Government announced major reforms to Australia's foreign investment policy. The reforms included:

- introducing a new national security test for foreign investment that raises national security concerns and falls beneath the screening threshold for the national interest test (which can include national security)
- requiring mandatory notification of proposed foreign investment in a 'sensitive national security business' (to be defined in regulation after consultation, but anticipated to include critical infrastructure, businesses involved in the manufacture or supply of defence or national-security related goods, businesses that own, store, collect or maintain sensitive data relating to national security or defence, and others)
- creating a new 'call in' power to allow the Government to review an investment not otherwise required to be screened or notified, and a 'last resort' review power to reassess approved investments where subsequent national security risks emerge

The Government also announced stronger penalties, compliance and enforcement powers, the intention to develop a new register of foreign ownership and a review of application fees. The Government said that it intended the reforms to commence 1 January 2021.

Source: Australian Government (2020), Frydenberg (2020a).

Treasury's Foreign Investment Division provides secretariat services to FIRB and is responsible for the day-to-day administration of the framework. Although the Treasurer is responsible for decisions regarding foreign investment proposals (supported by FIRB advice), the Treasurer delegates non-controversial decisions to junior ministers and senior Treasury staff (FIRB 2016, p. 11). Since 2015, the ATO has been responsible for administering residential real estate screening. In April 2017, it also took on responsibility for administering investments into non-sensitive commercial land and commercial reorganisations. The ATO assesses applications, collects fees, and is responsible for compliance and enforcement for residential real estate.

Legislation outside the foreign investment framework also imposes requirements and/or limits on foreign ownership in specific sectors, such as banking, airports and airlines, shipping, and telecommunications (box 2.2).

Box 2.2 Foreign ownership restrictions

Specific foreign investment and regulatory requirements in sensitive sectors include:

- foreign ownership in the banking sector must be consistent with the *Banking Act 1959*, the *Financial Sector (Shareholdings) Act 1998* and banking policy
- aggregate foreign ownership in an Australian airline (including Qantas) is limited to 49 per cent (with any one foreign holding capped at 35 per cent)
- the *Airports Act 1996* limits foreign ownership of some airports to 49 per cent, with a 5 per cent airline ownership limit; and cross-ownership limits (where a foreign investor owns more than 15 per cent of Sydney airport) between Sydney airport and either Melbourne, Brisbane or Perth airports
- the *Shipping Registration Act 1981* requires a ship to be majority Australian-owned if it is to be registered in Australia
- aggregate foreign ownership of Telstra is limited to 35 per cent and individual foreign investors are only allowed to own up to 5 per cent, and
- foreign ownership in Australian media businesses (television, newspapers and radio) above 5 per cent requires notification and approval, regardless of value.

In addition, foreign non-residents can only invest in Australian real estate if that investment adds to the housing stock — that is, established dwellings cannot be purchased. Temporary residents can only buy an established dwelling if it is used as their residence and sold when they leave Australia.

Sources: PC (2014) and FIRB (2017b).

What is the national interest?

The FATA empowers the Treasurer to prohibit an investment if they consider it would be contrary to the ‘national interest’. However, the definition of this term is ambiguous. While the legislation uses the term ‘national interest’, it is undefined in both the *Foreign Acquisitions and Takeovers Act 1975* and the related regulations.

This ambiguity gives Treasurers broad discretion to define the ‘national interest’ as they see fit, resulting in different definitions over time. For example, the Government originally intended the ‘national interest’ to primarily be an ‘economic benefits’ test with other factors considered second (such as consistency with Australia’s interests in exports, imports, local processing, research and development, industrial relations, defence objectives, environmental protection and regional development) (McMahon 1972).

The Australian Government’s current foreign investment policy outlines five factors that are typically considered:

-
- national security — the extent to which investments affect Australia’s ability to protect its strategic and security interests
 - competition — such as a customer gaining control over a producer, or an investor gaining control over the global supply of a product
 - other Australian Government policies, including tax
 - impact on the economy and the community — including ‘the extent to which the investor will develop the project and ensure a fair return for the Australian people’ (Australian Government 2019, p. 9)
 - character of the investor — whether the investor operates on a transparent commercial basis and is subject to adequate and transparent regulation and supervision.

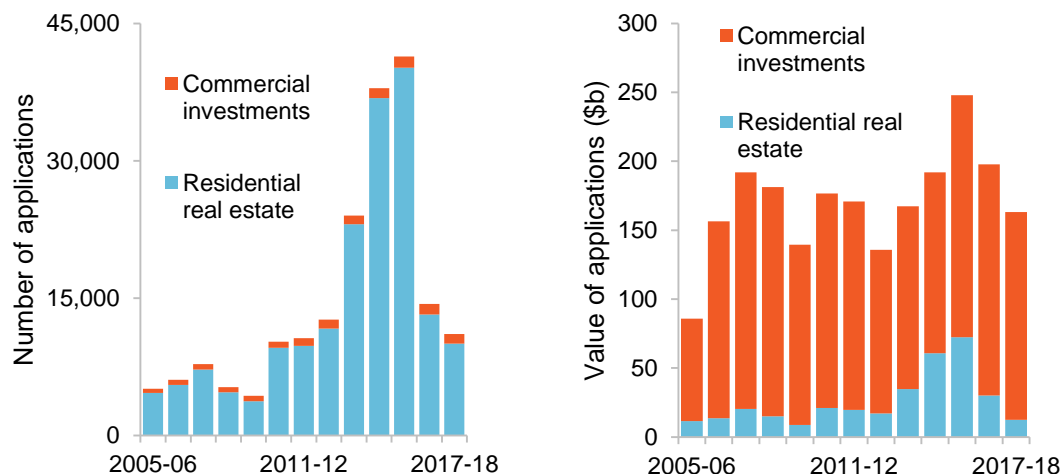
Other countries take different approaches. For example, unlike Australia’s negative national interest test, New Zealand has a positive test that puts the onus of proof on the applicant to demonstrate that their investment will positively contribute to New Zealand. The United States and United Kingdom only screen foreign investment for national security purposes. Canada uses a ‘net benefit’ test, which is determined by the relevant Minister.

The Australian Government’s recently announced ‘national security’ test will only apply to foreign investment in sensitive areas under the general screening threshold, while the national interest test will remain for foreign investment over the threshold (box 2.2).

FIRB approvals

In 2017-18, the total number of applications considered was 11 855, with 11 145 approvals and a total value of \$163 billion (FIRB 2019, p. 25). The number of applications was lower than previous years, particularly after the peak of over 43 000 in 2015-16 (figure 2.1).

Figure 2.1 FIRB applications
2005-06 to 2017-18



Source: FIRB annual reports (various years).

Residential real estate makes up the majority of approvals for foreign direct investment (FDI), accounting for about 90 per cent of the number of approvals in 2017-18, but only about 7.5 per cent of the value of approvals (FIRB 2019, p. 30).

The vast majority of foreign investments considered under the FATA are approved. From 2000-01 to 2017-18, FIRB approved (or exempted) 95.6 per cent of all applications. Applications that were not approved were either rejected by FIRB (0.2 per cent) or withdrawn by the applicant (4.1 per cent).

The rejection rate of applications has always been low, and has decreased in more recent periods (table 2.2). However, the rejection rate alone does not tell the full story for several reasons. First, the thresholds for screening have been raised significantly over the decades, meaning more foreign investment can come into the country without needing an application. Second, residential real estate applications make up a large majority of applications but are less likely to be rejected on national interest grounds unless they are clearly in breach of the foreign investment policy. Third, the number of applications has grown significantly over time.

Table 2.2 Applications and rejection and withdrawal rates

<i>Financial years^a</i>	<i>Rejection rate (% of applications)</i>	<i>Rejections</i>	<i>Withdrawal rate (% of applications)</i>	<i>Withdrawals</i>	<i>Applications</i>
1979–1984	2.89	255	4.76	420	8 829
1985–1990	1.90	332	6.01	1 049	17 449
1991–1996	1.79	470	7.50	1 970	26 279
1997–2002	1.87	524	7.78	2 220	28 537
2003–2008	0.57	209	6.81	2 129	31 274
2009–2014	0.06	62	2.93	3 055	104 247
2015–2017	0.01	10	3.90	2 733	70 058

^a Financial years beginning in the years indicated.

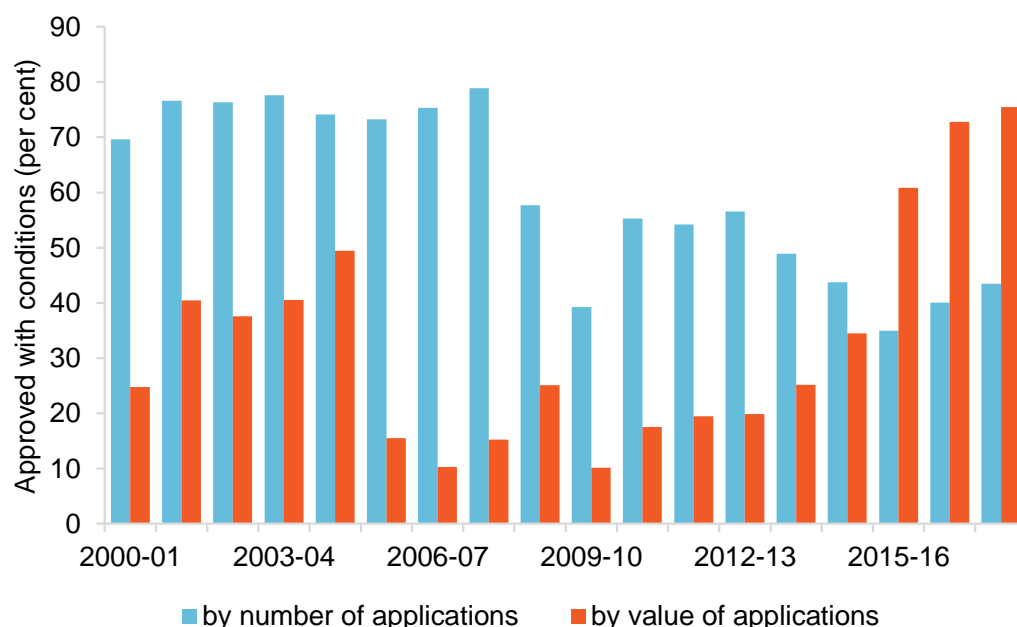
Source: FIRB annual reports (various years).

Several recent policy changes could affect the number of applications in the future. For example, it remains to be seen whether the new critical infrastructure security regime will deter foreign investors from considering investing in Australian infrastructure projects. But such an effect might not be observable in the applications data, as some projects may not even reach the application stage.

Conditional approvals

The Government commonly attaches conditions to foreign investment approvals (figure 2.2). In 2017–18, the Government applied conditions to 43 per cent of approved applications, which represented 75 per cent of the value of approved applications. The majority of conditions for non-real estate approvals related to tax (FIRB 2019, p. 24). Conditions have also been imposed related to national security (as in the sale of a 99 year lease on TransGrid; Morrison 2015a) or more broadly to manage national interest factors arising in large and complex acquisitions (FIRB 2018, p. 22). Applications to purchase new dwellings are usually approved without conditions, while applications to purchase vacant land are normally approved subject to construction being completed within four years (FIRB 2017b).

Figure 2.2 **FIRB applications approved with conditions**



Source: FIRB annual reports (various years).

The FATA gives the Treasurer the power to impose any condition that they think is necessary to ensure an investment, if taken, will not be contrary to the national interest. All commercial investment approvals with conditions attached require regular reporting to FIRB regarding compliance with those conditions (FIRB 2018, p. 45). The Treasurer can vary a condition or impose a new condition on a prior approval that was granted with conditions, if the investor consents or if the Treasurer is satisfied that it does not disadvantage the investor. The Treasurer cannot impose conditions on an investment that was approved without conditions.

Conditions can be as simple as giving the ATO specified information on a periodic basis but can also be much more extensive. For example, in November 2019, the Treasurer approved the China Mengniu Dairy Company's acquisition of Bellamy's Australia, an organic baby food company, subject to several conditions. These conditions require:

- a majority of the Bellamy's Board of Directors to be Australian resident citizens
- maintenance of the Bellamy's headquarters in Australia for at least ten years
- an investment of at least \$12 million in establishing or improving infant milk formula processing facilities in Victoria (Frydenberg 2019).

Fees and taxes

The Australian Government introduced fees for foreign investment applications in December 2015, collecting \$114 million in fee revenue in 2017-18 (FIRB 2019, p. 52). The fees vary according to the type of investment and its value.

- Fees for residential real estate applications range from \$5700 (for an acquisition of \$1 million or less) to over \$100 000 (for an acquisition over \$9 million).
- Application fees for commercial land acquisitions and business investment range from \$2000 (for an acquisition of \$10 million or less) to about \$100 000 (for an acquisition over \$1 billion).
- Application fees for agricultural land acquisitions range from \$2000 (for an acquisition of \$2 million or less) to about \$100 000 (for an acquisition over \$10 million).

The Australian Government also introduced a ‘vacancy fee’ for foreign owners, of residential real estate commencing from December 2017. Under the new regime, foreign owners of residential dwellings in Australia are required to pay an amount equivalent to the application fee each year if their dwelling is not occupied or rented out for more than six months of the year (ATO 2019a).

In addition, all state governments charge additional stamp duties surcharges on foreign purchasers of property, while three states and the ACT also charge higher rates of land tax on foreign owners if it is not their principle place of residence (table 2.3). The stamp duty surcharges have all been introduced over the past five years, starting with Victoria in 2015.

Table 2.3 State and territory stamp duty surcharges and land tax

<i>State/Territory</i>	<i>Stamp Duty Surcharge</i>	<i>Absentee Land Tax</i>
	<i>Per cent of dutiable value</i>	<i>Per cent of unimproved value</i>
New South Wales	8	2
Victoria	8	2
Queensland	7	2
Western Australia ^a	7	Nil
South Australia	7	Nil
Tasmania	7	Nil
ACT	N/A	0.75
NT	Nil	N/A

^a From 2019 to 2021, there will be a 75 per cent stamp duty discount for purchases of off-the-plan apartments, which also applies to the stamp duty surcharge.

Sources: State and territory revenue offices.

2.2 Australia's FDI policy restrictiveness

Australia is generally open to foreign investment, but is less open than other Organisation for Economic Cooperation and Development (OECD) member countries, according to a comparative measure of FDI restrictiveness (box 2.3).

- The OECD FDI restrictiveness index is scored on a scale from 0 to 1 — Australia scored only 0.149, less than half the score of the Philippines (0.374) which was most restrictive country measured (in 2018).
- Australia was the fifth most restrictive of the 36 OECD countries in 2018 (figure 2.3). Most of this was due to the screening and approval regime, of which Australia had the second most restrictive in the OECD (behind New Zealand) out of the 12 countries with a screening regime.
- Australia also had the fifth most restrictive real estate investment regime in the OECD and was one of only six countries that subjected real estate investment to screening and approval.

Box 2.43 The OECD FDI restrictiveness index

The OECD's FDI restrictiveness index scores regulatory restrictions on FDI across four measures:

- equity restrictions
- screening and approval requirements
- restrictions on key foreign personnel
- other operational restrictions, such as limits on purchases of land or repatriation of profits and capital.

Each measure is scored from 0 (no restrictions) to 1 (all investment restricted) across 22 sectors. The score for each sector is the sum of the scores for all four measures, capped at 1.0. A country's overall score is the average across all sectors.

The index does not capture the implementation or administration of the regulatory regime, nor does it include measures maintained at the sub-national level. It also does not include measures taken for reasons of public order or national security, which (as the OECD acknowledges) can introduce a bias in favour of countries that place national security measures under a different system.

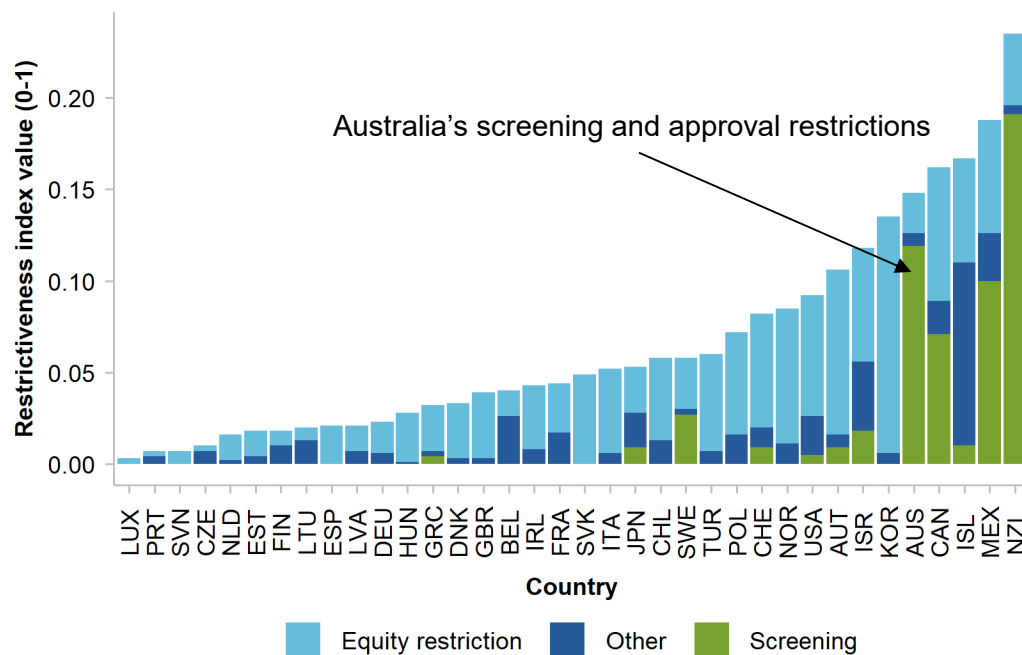
Source: Kalinova, Palerm and Thomsen (2010).

However, the OECD restrictiveness index is not definitive. It does not, for example, measure the administration of investment screening, nor does it include fees and taxes. Neither is national security screening included in the index. Nonetheless, analysis from the OECD suggest that the restrictiveness index can explain some of the differences in countries' foreign investment levels (Mistura and Roulet 2019).

Since their creation, Australia's foreign investment policies and screening processes have undergone many changes (a detailed timeline is in appendix C). On the one hand, foreign investment policy has become *less* restrictive, as general screening thresholds and eligibility

criteria have risen substantially. On the other hand, policy has become *more* restrictive, as new requirements have been introduced to guard against national security risks, while applications to invest in residential real estate and agriculture and agribusinesses have faced added restrictions.

Figure 2.3 Australia's foreign investment restrictiveness
OECD restrictiveness index^a, 2018



^a The index is aggregated across sectors, between 0 (least restrictive) and 1 (most restrictive).
Source: OECD (2019b).

3 The benefits and costs of foreign investment

Key points

- Over the past two centuries, foreign funding has allowed the Australian economy to make more investments in capital than would be possible if financed through domestic savings.
 - Expanding the amount of capital per worker contributes to higher labour productivity, which generally leads to increased wages and output across the economy.
 - Previous research estimated that decreasing foreign investment flows by a quarter would decrease the wages of Australians by about 2 per cent.
 - Modelling for this report estimates that the cost of running a more restrictive foreign investment policy regime would be between \$0.8 billion and \$7.1 billion each year in forgone national income, due to a loss of \$19–\$182 billion of net foreign capital.
- Foreign investment brings ‘spillover’ impacts too, both positive and negative, although their impact on the economy is much more difficult to quantify or model.
 - On the positive side, they include access to new technologies and management practices, increased competition and greater participation in international supply chains.
 - On the negative side, competition from efficient foreign businesses can result in some Australian firms going out of business, and there are ongoing worries about whether investors generate negative social and environmental spillovers by not adhering to domestic regulations.
- Foreign investment also stirs strong community concerns. While Australians are generally supportive of globalisation and free trade, many perceive the risks and threats associated with foreign investment more prominently than the benefits.
 - Foreign investments in Australia’s residential real estate or agricultural land are particularly sensitive among the community, despite a lack of evidence that such investment does any harm, and considerable evidence of its benefits in the agriculture sector.
- The nature of the risks from foreign investment has shifted in recent years. Additional attention is now focused on national security risks associated with sensitive sectors or critical infrastructure assets, and on the difficulty of collecting tax from multinational corporations.
 - National security concerns have received greater prominence due to the rising share of our inward investment being sourced from China. For the first time, one of our largest investors is not a democracy or a military ally.
 - Evidence also suggests that multinationals are becoming increasingly aggressive in their use of tax minimisation strategies, such as thin capitalisation and transfer pricing.

Foreign investment flowing into Australia has supported our economic growth and improved living standards over the past two centuries, primarily through two mechanisms.

- Access to additional funds for investment, increasing output and gross national income (section 3.1).
- Productivity-enhancing spillovers from foreign direct investment (FDI), through the spread of knowledge from world-leading firms (section 3.2) — spillovers tend to occur through the direct transfer of advanced technology, enhanced competitive pressures on domestic firms, and greater human capital development.

Foreign investment can be associated with negative spillovers too. For example, there are ongoing worries about whether foreign investors will create negative social and environmental spillovers by not adhering to Australia’s regulations, and the flipside of increased competition is that some Australian firms will be disrupted or even forced out of business.

Moreover, foreign investment stirs strong community concerns. For example, in 2019, 90 per cent of respondents to a Lowy Institute poll believed that foreign investment was a ‘critical’ or ‘important’ threat to Australian interests (Kassam 2019, p. 29), while another survey found that 80 per cent of respondents either ‘somewhat’ or ‘strongly’ agreed that there should be more restrictions on foreign ownership (Jasper, Felton-Taylor and Vidot 2016).⁷

Australia’s foreign investment policy reflects these community concerns and specific risks, including threats to national security (section 3.3), risks of multinational tax avoidance (section 3.4), and concerns about the purchase of Australian residential real estate and agricultural land (section 3.5).

These issues play out differently for different types of investments. Most commercial investments will pose no national security risks, and the economic effects from capital inflows (including the spillover benefits of technology, management capabilities and integration into global supply chains that can come with foreign direct investment) will be overwhelmingly positive. For investments in sensitive sectors or that give access to confidential or personal data, national security risks may come to the fore. Residential real estate investment generally offers no spillover benefits and poses no national security risks.

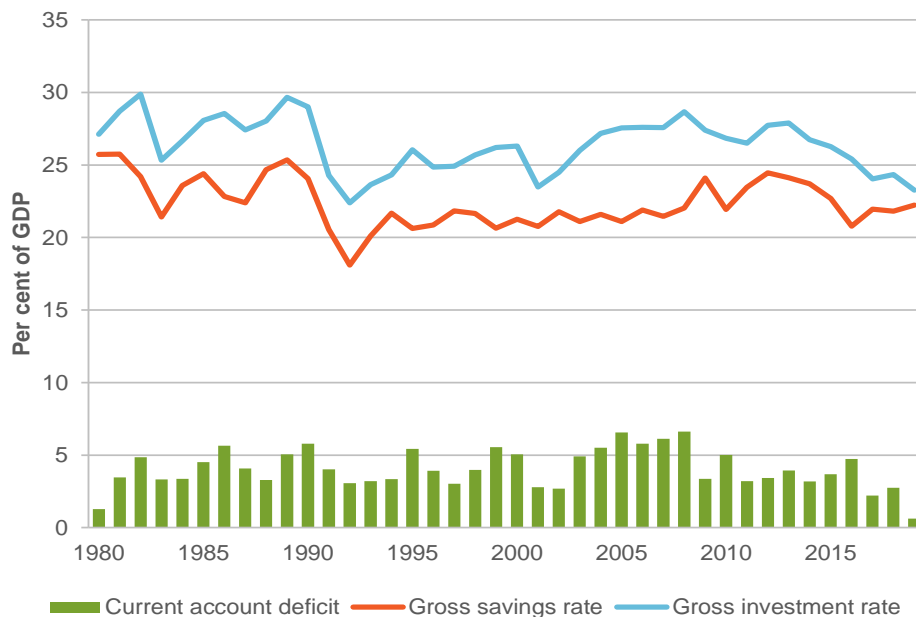
⁷ Yet most Australians are still supportive of globalisation and free trade, with more than 70 per cent of respondents agreeing that globalisation has been good for Australia and that free trade has been good for their standard of living (Kassam 2019, pp. 33–34).

3.1 Foreign investment allows access to additional capital funding

A primary mechanism by which foreign investment generates economic benefits is by providing access to additional funding, beyond what an economy can save from domestic income. This allows recipient countries ‘to accumulate more productive real capital than would be the case if domestic saving alone determined domestic investment’ (Layton and Makin 1993, p. 36). Foreign funding lowers the cost of capital for domestic investments, increasing the number of viable investments for both households (such as through lower mortgage rates) and businesses (Makin 2008, p. 8; OECD 2002, p. 22).⁸

Australia has a long history of receiving inflows to allow investment above what could be funded through domestic savings. This is reflected in Australia’s savings-investment gap (figure 3.1), which is covered by inward foreign investment in the balance of payments (Gali and Taplin 2012, p. 6; Layton and Makin 1993, p. 36; Treasury 1999, pp. 1–2).

Figure 3.1 The savings-investment gap and the CAD
Annual savings, investment and current account deficits, 1980–2019^{a,b}



^a Gross savings is measured as gross national income less final consumption expenditure. ^b Gross investment is measured as the sum of gross fixed capital formation and changes in inventories.

Source: Commission estimates, based on ABS, *Australian National Accounts: National Income, Expenditure and Product, Jun 2019*, cat. no. 5206.0 (tables 36 and 38) and *Balance of Payments and International Investment Position, Jun 2019*, cat. no. 5302.0 (table 30).

⁸ Investment can occur in either tangible assets (such as transport infrastructure, residential construction, farm equipment or new mining projects) or intangible assets (such as the skills and knowledge of the workforce, research and development, software or intellectual property).

The savings-investment gap reflects a wealth of investment opportunities compared to some other countries — due to our abundant endowment of natural resources, highly-educated and productive workforce, growing population, strong institutions and stable macro-economy (chapter 1) — rather than a weakness in domestic savings.⁹ In 2018, for example, Australia’s rate of investment (at 24.3 per cent in figure 3.1) was higher than the rate in almost every other advanced economy, which averaged 21.9 per cent (IMF 2019b, table A14).

How additional capital funding delivers benefits

Foreign funding helps to expand Australia’s economy through investment in new machinery, transport equipment, buildings and other structures. In turn, expanding the amount of capital per worker (so called ‘capital deepening’) contributes to labour productivity growth, which generally leads to both increased wages (Lowe 1995, p. 44) and gross domestic product (GDP). While some of the added output from foreign investment is remitted overseas as the cost of foreign capital funding (through interest payments, dividend distributions, capital gains, etc.), the gap between the added production and remittances to foreign capital owners creates a net increase in gross national income (GNI, a common measure used to assess economic living standards) for Australia (Gali and Taplin 2012, p. 8; Makin 2008, p. 8).

Even where a foreign investor buys an Australian asset and simply maintains it (without adding to output), this is still beneficial, as it can help to free up the seller’s scarce domestic savings for investment elsewhere (Kelly and Graziani 2004, p. 35; Makin 2008, p. 11; OECD 2002, pp. 9–10). Indeed, if the foreign investor paid a higher price than any domestic investor, the Australian seller has made a greater capital gain (or lower capital loss). Meanwhile, domestic bidders may still decide to invest elsewhere.

Ultimately, without access to foreign funding for investment, Australia’s standard of living would be worse off, as Australians would either have to sacrifice *current* consumption (to maintain the same investment level) or *future* consumption (by reducing current investment, leading to lower income in the future) (McKissack and Xu 2016, p. 10; Minifie 2017, p. 28; Vernon et al. 1965b, p. 987). On the whole, ‘foreigners are not buying up Australia’s stock of wealth; they are investing in ways that add to it’ (Switzer 2008, p. 10).¹⁰

⁹ Australia’s savings rate is comparable to that of other developed countries. In 2018, for example, Australia’s savings rate (at 21.8 per cent in figure 3.1) was above the rate in the United Kingdom (13.3 per cent) and the United States (19 per cent) and close to the average (22.7 per cent) for advanced economies (IMF 2019b, table A14). A key contributor to our relatively strong savings rate has been the gradual growth in compulsory superannuation (Bishop and Cassidy 2012).

¹⁰ Australia’s openness to *outward* investment also brings benefits, as Australian investors (including superannuation funds) can earn higher returns overseas than domestically.

Quantifying the benefits of foreign capital funding

It is difficult to quantify the benefits of foreign investment, not least due to issues with the direction of causality. Econometric estimation techniques struggle to disentangle whether foreign capital is attracted to the opportunities of an expanding economy, or is itself providing an impetus to growth (Iyer, Rambaldi and Tang 2009, p. 1526). The most common method is to use a general equilibrium model to examine what would happen if foreign investment either decreased or disappeared.

The results of these studies vary (table 3.1), but unambiguously show that foreign investment is positive for the Australian economy, leading Treasury to conclude that, ‘other things being equal, restrictions on capital inflow would reduce the wellbeing of Australians’ (Gali and Taplin 2012, p. 16). Similarly, the Business Council of Australia concluded that the Government should aim to increase foreign investment, as this would ‘increase [Australia’s] capital stock, lift productive capacity and output, raise demand for labour and boost real wages’ (BCA 2010, p. 5).

Table 3.1 Macroeconomic estimates of foreign investment impacts

<i>Author</i>	<i>Methodology</i>	<i>Results</i>
Gali and Taplin (2012)	Used the Monash Multi Regional Forecasting computable general equilibrium (CGE) model. The primary scenario estimated the effects of a permanent drop in foreign inflows by 1% of GDP (equivalent to long-run annual capital inflows falling by 25%) over ten years. An alternate scenario modelled a reduction in capital inflows of 4% of GDP, equivalent to Australia shutting itself off to new foreign investment.	Primary scenario showed changes (compared to the baseline) in the capital stock (-1.5%), GNI (-0.6%), and real wages (-2%). Alternate scenario showed larger changes in the cost of capital (+5.6%), the capital stock (-5.2%), GNI (-2.0%) and real wages (-7.2%).
Access Economics (2010)	Used an in-house CGE model to estimate the impact of a 20% decrease in inward foreign investment flows over ten years (among other scenarios).	The model showed changes in capital prices (+1.9%), capital stocks (-4.5%), real GDP (-2.2%) and real wages (-1.9%).
Iyer, Rambaldi and Tang (2009)	Used Granger causality analysis. Also estimated a cointegrating relationship between GDP and FDI (among other variables).	Found that FDI Granger causes changes in GDP (not the other way around). Estimated that a 10% increase in FDI would increase GDP by nearly 0.5%.
Faeth (2006)	Used Granger causality analysis of relationships between FDI and investments, GDP, imports and exports.	Found that increases in FDI inflows are associated with increases in investment growth, GDP growth, import growth (indirectly, through additional GDP growth) and FDI itself, but also with a reduction in export growth.
Layton and Makin (1993)	Used an estimation of a Cobb-Douglas function to simulate the effect of an elimination of the current account deficit (and resulting drop in capital) on GNI.	Estimated that real per capita GNI growth between 1984-85 and 1988-89 was approximately 15% higher than it would have been in the absence of foreign capital inflows.

How costly are restrictive FDI policies?

As FDI adds to Australian incomes, restrictive policies have the potential to detract from incomes. The best way to estimate the effects of FDI restrictions is to draw comparisons across similar advanced economies. Organisation for Economic Cooperation and Development (OECD) countries have vastly different FDI regulatory regimes and have made changes over time. Comparing outcomes based on each country's inward investment each year allows rough estimates of the effect of policy changes on the Australian economy.

Estimating the costs of restrictions thus starts with an understanding of how restrictions affect the stock of FDI. A recent OECD working paper on the determinants of FDI (Mistura and Roulet 2019) provides the best available estimates. They estimated that a 10 per cent increase in the OECD's restrictiveness index (outlined in chapter 2) is associated with a decrease in inward investment stocks of 2.1 per cent. A limitation of this study is the significant difficulty in measuring the restrictiveness of investment policies (appendix A).

The Commission has combined these estimates of the impact of policy on investment with a model of global trade and investment in order to produce estimates of the effects of foreign investment restrictions on Australian wages and incomes (appendix A). The approach taken was to use the PC Global computable general equilibrium (CGE) model (PC 2017a). The model is based on the Global Trade Analysis Project (GTAP) model (Hertel 1997), expanded to include foreign investment flows and capital ownership between bilateral partner countries.

The modelling comparison is with a scenario where Australia's foreign investment policy is more restrictive, resulting in an increase in Australia's restrictiveness index. The exact nature of the added restrictions on foreign investment are not specified or modelled.¹¹ However, to provide a plausible scenario for the comparison, New Zealand's restrictiveness index score is used as a proxy, as it is the most restrictive country in the OECD¹² and has a similar geopolitical context to Australia. This would equate to an increase of about 60 per cent in Australia's restrictiveness index.

Modelling this scenario provides a range of estimates for the potential effect of foreign investment restrictions on the wellbeing of Australians. The estimates rely on judgments about the restrictiveness of different policies in different countries, and reflect assumptions about how foreign investment flows through to economic activity.

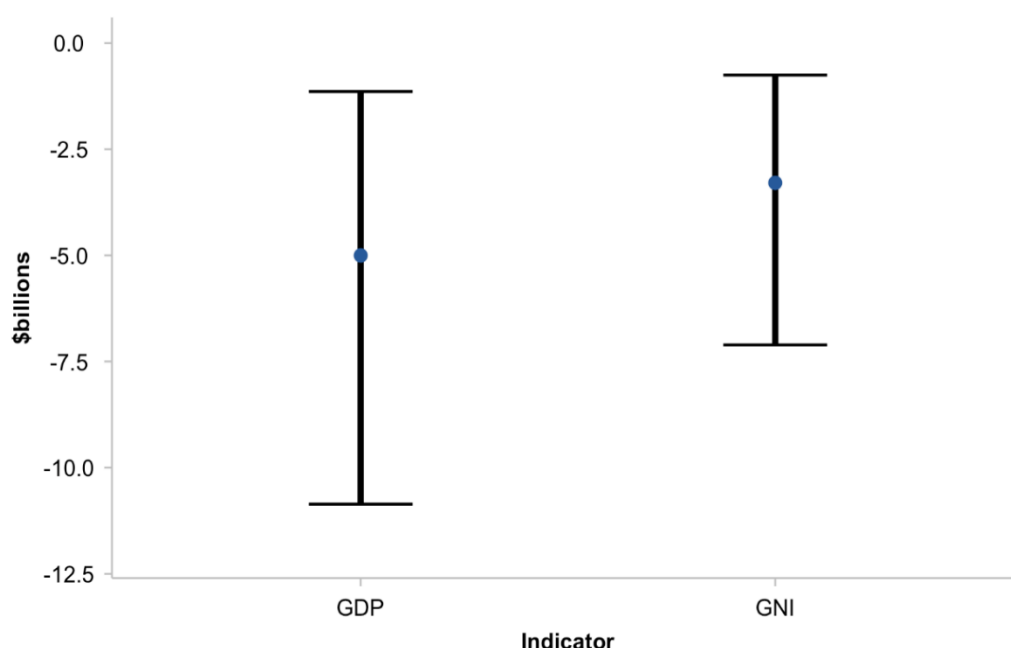
Overall, the modelling estimates indicate that the cost of added foreign investment restrictions to Australians is material, though not large in the context of Australia's nearly \$2 trillion economy. Increasing Australia's restrictions on foreign investment (to a similar

¹¹ Conceivably, the added restrictions could include tougher screening criteria, added equity restrictions, a reinterpretation of the 'national interest' test, or many other policy changes, all of which could be driven by strong community concerns about foreign investment.

¹² New Zealand screens all foreign investment with lower monetary thresholds and a 'positive' national interest test (i.e. potential investors are required to demonstrate that their investment is in the national interest, whereas Australia's regime is a 'negative' test that only allows the Treasurer to block investments when satisfied it is *contrary* to the national interest).

level of restrictiveness as New Zealand) would reduce GNI by between \$0.8 and \$7.1 billion (or \$82–\$731 per household per year), due to a loss of \$19–\$182 billion of net foreign capital¹³ (figure 3.2).

Figure 3.2 Restricting FDI reduces Australian incomes
Simulations of the effect on the Australian economy of adopting a more restrictive FDI regime, similar to the level of New Zealand^{a,b}



^a Percentage changes from the model are applied to current Australian gross domestic product and gross national income levels. ^b Error bars show high and low sensitivity tests based on estimates of the elasticity of foreign investment to FDI restrictiveness that are two standard deviations above and below the central estimate.

Source: Commission estimates (appendix A).

Although there is uncertainty around these estimates and they are sensitive to assumptions (sensitivity analyses are presented in appendix A, along with the methodology and caveats), the results point in one direction — Australian incomes would be lower if foreign investment restrictions were higher. This aligns with New Zealand’s experience, where research indicates that its more restrictive approach may have led to its shortage of capital, which has been linked to low labour productivity (Conway 2018).

In addition, such CGE modelling exercises cannot capture the broad array of spillovers that, on the whole, are likely to exacerbate the negative effect of foreign investment restrictions on incomes.

¹³ Net foreign capital refers to foreign capital inflows less domestic capital outflows — i.e. the net change in capital stocks invested in Australia.

3.2 Direct investment can also lead to spillovers

The other way that foreign investment can provide advantages to Australia's economy is through spillover benefits that ultimately improve living standards. This is particularly the case for commercial *direct* investment, which comes with more engagement from multinational firms than other forms of investment, such as portfolio investment or residential real estate investment (chapter 1).

Often, direct investors are sophisticated, highly-productive businesses, at the international 'frontier' of technology, knowledge and innovation (as success in their domestic markets is a precondition for attaining multinational status).¹⁴ The Department of Foreign Affairs and Trade (DFAT 2018) noted that:

Globally, the majority of private research and development is undertaken by multinational enterprises, which possess the necessary size, scale and technical capacity to develop and disseminate new technologies.

Many of these advantages are then passed to the foreign investor's Australian activities, making the foreign-owned or affiliated firm in the recipient country more efficient than its domestically-owned peers, and flowing through to higher wages for their employees.

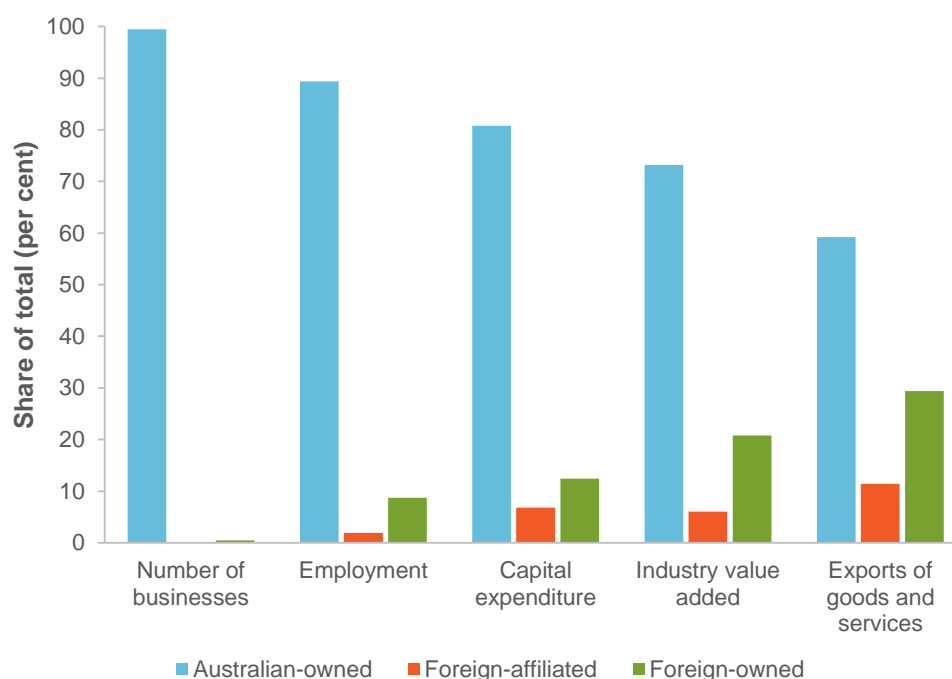
- In Australia, for example, foreign ownership is associated with higher levels of 'strategic management', which is positively correlated with innovation, collaboration, labour productivity, and responsiveness to skill and supply chain issues (Moran et al. 2018, p. 22).
- Similarly, foreign-affiliated businesses (between 10 and 50 per cent foreign ownership) and foreign-owned businesses (over 50 per cent foreign ownership) made 19 per cent of all expenditure on capital in 2014-15, contributed 27 per cent of total industry value added and produced over 40 per cent of Australia's exports (figure 3.3).

However, the technological advantages of foreign investors are hard to contain within foreign owned business. Technology, innovation, technical know-how and management capability tends to leak into the rest of the economy as a 'spillover effect', leading to improved productivity for local firms (BCA 2010; McKissack and Xu 2016; Roy 2016; Treasury 1999; Vernon et al. 1965a, p. 280). In practice, these spillovers tend to occur through four interrelated (but slightly different) mechanisms:

- the direct transfer of advanced technology and methods
- enhanced competitive pressures for domestic firms
- increased domestic innovation
- greater human capital development.

¹⁴ The technical advantage of foreign investors can come in the form of 'embodied' knowledge (such as proprietary technologies, advanced capital goods and production techniques) or in 'disembodied' changes (such as managerial know-how and employee skills improvement) (OECD 2001, p. 9).

Figure 3.3 From foreign things, big things grow
Proportion of Australian business activities by ownership^{a,b}, 2014-15



^a 'Foreign-affiliated' are businesses with between 10 and 50 per cent foreign ownership. ^b 'Foreign-owned' are businesses with over 50 per cent foreign ownership.

Source: ABS, *Economic Activity of Foreign Owned Businesses in Australia, 2014-15*, cat. no. 5494.0.

Foreign investment can be associated with negative spillovers too, where the impact of an investment has repercussions for the broader economy and community. Some of this reflects the downside of otherwise positive outcomes for Australia, such as increased competition that results in some Australian firms being disrupted or forced out of business. Other negative spillovers relate to worries about whether foreign-owned firms will adhere to Australia's social and environmental regulations.

Vertical and horizontal technology transfers

Technology transfers and diffusion occur in many ways.¹⁵ The two primary channels associated with foreign investment are vertical linkages — 'with suppliers or purchasers in the host countries' — and horizontal linkages — 'with competing or complementary companies in the same industry' (OECD 2002, p. 13).

¹⁵ Aside from through foreign investment, technology is also transferred through the internationalisation of knowledge and R&D, its embodiment in internationally traded goods, and the international licensing of technology (Caves 1974, p. 185).

The evidence of positive spillovers through *vertical* linkages is strong. Foreign investors often provide technical assistance, training and advice to firms up and down the supply chain, helping to modernise their facilities and techniques. By facilitating these vertical linkages, investors get a direct benefit from improved performance through their ‘backward’ linkages with local suppliers, as well as more efficient downstream customers (such as logistics firms) (Blomström and Kokko 2001; Javorcik 2004; Mistura and Roulet 2019; Newman et al. 2015; OECD 2001, 2002; Rojec and Knell 2018).¹⁶

Evidence of *horizontal* linkages generating spillovers through the demonstration of new technologies and management techniques is more difficult to observe (Gorg and Greenaway 2004; Mistura and Roulet 2019; OECD 2001, 2002). While some studies have found evidence that new technology is transferred between foreign investors and competing domestic firms under particular circumstances (Caves 1974; Javorcik and Spatareanu 2003), other studies have found no evidence (Javorcik 2004; Newman et al. 2015) or have even found negative effects on the productivity of domestic competitors (Aitken and Harrison 1999; Sabirianova, Svejnar and Terrell 2005).

The strength of linkages with domestic supply chains also affects the extent of spillovers (Balsvik and Haller 2010; Crespo and Fontoura 2005; Rojec and Knell 2018). There is greater evidence of positive spillovers when the foreign investor acquires an existing asset or producer (through a merger or acquisition), rather than ‘greenfield’ investment with no established links to other firms.¹⁷

Competitive pressures

Foreign investment also drives the uptake of new technology by incumbent firms seeking to improve their business practices and compete with the foreign entrant to maintain market share (BCA 2010; Evans 1999; Minifie 2017, p. 28; OECD 2002; Treasury 1999). However, there have been concerns that the entrance of foreign investors could create new monopolies, as the more efficient foreign firms overwhelm local competitors and force them out of business (Blomström and Kokko 2001, p. 4; Newman et al. 2015, p. 170; OECD 2001).

These concerns have a long history — for example, MacDougall (1960, p. 27) suggested that growth by foreign firms ‘might put them in a monopolistic position in which they could exploit Australian buyers’. Yet foreign firms that are new to markets also generate considerable

¹⁶ Vertical transfers to suppliers and customers tend to be more likely to occur where the asset or business is only partially foreign owned, as wholly-owned foreign projects are less likely to source and supply goods locally. However, this is partly offset by foreign investors transferring more resources, know-how and advanced technology to wholly-owned projects, as the investors can maintain more control and avoid leakages to competitors (Crespo and Fontoura 2005; Javorcik and Spatareanu 2003).

¹⁷ The technological level (or ‘absorption capacity’) of competing domestic firms can also have an impact through ‘threshold effects’, where a foreign investor only ‘forces local firms to become more productive in sectors where best practice technology lies within their capability’ (Blomström and Kokko 2001, p. 6). Several studies have found empirical evidence for this result (Bruno and Cipollina 2018; Crespo and Fontoura 2005; Haddad and Harrison 1993; Lipsey 2004; Rojec and Knell 2018; Roy 2016).

benefits for consumers, by introducing new and better products or by charging lower prices (Blomström and Kokko 2001, p. 3; Borensztein, De Gregorio and Lee 1995, p. 18; MacDougall 1960, p. 27; OECD 2001, p. 17).

Equally, competition from foreign investors can disrupt a sheltered local oligopoly, reducing inefficiencies created from economic rents. The oligopoly-disrupting effect is particularly likely to occur in industries where barriers to entry are high (such as utilities), as only sophisticated foreign investors have the resources to enter and compete (Blomström and Kokko 2001; Caves 1974; OECD 2001). ALDI's entrance into the Australian supermarket industry demonstrates some of these effects (box 3.1).

Box 3.1 Case study — ALDI in Australia

The German discount retailer ALDI entered the Sydney's supermarket industry in January 2001 (Marsh 2018). By November 2019, ALDI's Australian operations had grown to 544 stores across the country (ALDI 2019), obtaining 11.4 per cent of market share in December 2018 (Roy Morgan 2019). Much of this market share has come from Coles and Woolworths, with their combined share of the market falling from nearly 80 per cent in the early 2000s (Jacenko and Gunasekera 2005; PwC 2007) to about 62 per cent in December 2018 (Roy Morgan 2019).

The Australian Competition and Consumer Commission (ACCC) concluded in 2008 that ALDI 'has been a vigorous price competitor since its entry into Australia' (ACCC 2008, p. xiv). The ACCC also found that ALDI had significantly influenced pricing at nearby supermarket chains, particularly in private label (own-brand) products where similar products are stocked by ALDI.

Domestic innovation and research

Foreign investment can have mixed consequences for innovation and research and development (R&D) in Australia — the *creation* of home-grown productivity-enhancing technologies, products and processes.

The evidence from Australia and overseas suggests that technological transfers through inward FDI reduce the need for domestic innovation.¹⁸ In particular, FDI reduces the need for foreign-owned firms in Australia to innovate, as the firm can rely on technology transfers from its parent company instead.¹⁹ To develop economies of scale in innovation and

¹⁸ In Australia, foreign owned firms are significantly less likely to partake in product and process innovations (Rogers 1999), and those with a foreign owner located in Asia appear to undertake significantly less R&D expenditure (Lofts and Loundes 2000, p. 12). International studies point to foreign ownership reducing domestic R&D activity in Northern Ireland (Harris 1991) and the UK (Bishop and Wiseman 1999; Love and Roper 1999) as research generally occurs at the headquarter location, not within the subsidiary. In Germany, service sector firms with headquarters abroad were also significantly less likely to engage in product or process innovations than domestic German firms (Blind and Jungmittag 2004).

¹⁹ There are also some studies that dispute this conclusion. For example, an analysis of Scottish manufacturing firms found that foreign ownership had a positive effect on the likelihood of product innovation (Love, Ashcroft and Dunlop 1996, p. 743).

research, multinationals often co-locate R&D in a single jurisdiction (normally their country of origin).

The evidence also suggests that the competitive forces unleashed by inward foreign investment can encourage ‘reciprocal’ innovation in competing Australian-owned companies, partially offsetting the impact of technology transfers. For domestic competitors, there is some evidence that increased competition created by foreign investors spurs increased R&D spending and quicker adoption of new innovations (OECD 2001).²⁰ The strength of this effect depends on the extent of the rivalry between the businesses, and is less likely if the foreign-owned firm enters an industry where domestic firms lag far behind international practice and quickly achieves ‘an overwhelming lead’ (Aghion et al. 2009, p. 20; Blind and Jungmittag 2004, p. 211).

Outward foreign investment *from* Australia may also affect domestic innovation, through the impacts on the intellectual property (IP) rights of Australian innovators. In particular, there are concerns that if an Australian investor’s IP rights are not adequately protected in other countries, this could discourage further innovations over the long-run (box 3.2).

Skills and workforce development

Foreign investment can also have positive impacts on the skills and knowledge (‘human capital development’) of the local workforce in the recipient country.

Primarily, this occurs through foreign-owned firms directly providing training to their local employees, whether through formal (seminars or courses) or informal (on-the-job) mechanisms. As the foreign investor is normally closer to the technological frontier than local competitors (discussed above), this transmits new skills to local workers, such as better management or production techniques, that can be passed on to other areas of the economy as employees move jobs (BCA 2010; Blomström and Kokko 2001; Bruno and Cipollina 2018; Crespo and Fontoura 2005; OECD 2001, 2002).

²⁰ A range of other studies support this conclusion. For example, two separate studies in Germany — of manufacturing firms (Bertschek 1995) and service sector firms (Blind and Jungmittag 2004) — found that a greater share of FDI in an industry sector leads all firms in that sector to have a greater likelihood of product and process innovation. A study of Estonian manufacturers similarly confirmed that process innovation by incumbents increases after the entry of a foreign investor (Vahter 2010).

Box 3.2 **Technology transfers and intellectual property (IP) rights**

Domestic laws to enforce IP rights are often ineffective at protecting Australian IP overseas, leading to problems such as the counterfeiting of labelling belonging to high-quality Australian winemakers (PC 2016a, pp. 554–555). Enforcement overseas requires international cooperation and coordination through multilateral treaties, bilateral resolutions and mutual arrangements, as Australia cannot unilaterally enforce its IP rights elsewhere (PC 2016a, pp. 581–582).

As with other concerns, much of the focus on IP rights overseas has been directed at China — joint venture requirements for foreign investors seeking access to the Chinese market often compel forced technology transfers to a partnered Chinese firm (Kirchner and Mondschein 2018, p. 6; OECD 2019c; *The Economist* 2019).

The US government has also accused China of undermining IP rights ‘to access the crown jewels of American technology and intellectual property’ through other ‘aggressive’ practices (The White House 2018, p. 2), such as cyber-enabled theft, reverse engineering, mandated data localisation, and adverse approvals processes (USTR 2018).

Yet, despite the risks to their IP rights, many companies still choose to invest in China, as the cost of missing out on its market would be too great (*The Economist* 2013). Moreover, the transfer of technology and IP from more advanced countries to less-productive economies is one of the key benefits of FDI for recipients (discussed above), and ‘ideas want to be free and new technologies will eventually diffuse across international borders’, which is ‘mostly for the better’ (Kirchner and Mondschein 2018, p. 7). There is also a long history of rising powers copying the secrets of more advanced economies:

... in the Anglo-French wars of the 1700s France recruited British defectors to unlock the secrets of coal technologies. In the subsequent century America stole British designs for looms and trains. Japan mimicked the West during the Meiji Restoration. South Korea, Taiwan and Singapore industrialised by buying and stealing Western ideas on everything from ships to chips. (*The Economist* 2018)

History also suggests that the trend will eventually reverse. As countries develop (aided by technology transfers), they eventually produce their own ideas that others wish to copy. As they switch from being a net ‘importer’ of innovation to a net ‘exporter’, their firms and governments begin to value the enforcement of IP rights. There is some indication that this process has already started in China, with Huawei now the world’s most prolific filer of international patents, and Chinese companies facing enforcement problems of their own as they invest in South-East Asia (Huang and Smith 2019; *The Economist* 2019).

More broadly, demand by foreign-owned firms for more productive workers can help to create incentives for locals to independently improve their own skills and education, as the locals may wish to seek employment with the investor (Blomström and Kokko 2001). By increasing firm productivity, technology transfers from foreign investors can also help to increase the rate of return to education (Nelson and Phelps 1966).²¹

²¹ In developing economies, foreign investment can also generate improved access to formal tertiary education through scholarships or joint ventures with local universities. Some governments also seek to indirectly attract foreign investment by improving the formal education and human capital of their residents, creating a more attractive investment destination (Blomström and Kokko 2001; OECD 2002).

Social and environmental impacts

There are also a number of other areas where concerns have been raised about the impact from foreign investment, including on:

- environmental protections — particularly worries that FDI can be used to shift damaging production to Australia, in a ‘race to the bottom’ on environmental standards
- immigration levels — foreign investment has occasionally been conflated with concerns about the potential displacement of local workers by foreign labour
- other local rules — concerns that foreign investors might undermine other domestic rules of business (such as work health and safety standards or minimum/award wages), as they lack a cultural affinity and responsibility to the recipient country (Blomström and Kokko 2001; Bruno and Cipollina 2018; CEDA 2008; Fisher, Stoeckel and Borrell 1998; Jasper, Felton-Taylor and Vidot 2016; Newman et al. 2015; OECD 2001, 2002; Uren 2015).

All of these issues are important areas of community concern and for policy consideration. However, none of these concerns are unique to foreign investment. Some Australian-owned businesses, for example, have recently been found to have not complied with employment award conditions. Policy that targets the issue directly is likely to be more effective and have fewer economic costs than attempting to achieve these objectives through foreign investment restrictions.

3.3 Foreign investment and national security risks

National security — the safety of a country from war, espionage, serious and organised crime, biosecurity threats, terrorism and cyber-attacks — is the most important function of government. Arguably, national security risks are growing and becoming more difficult to contain in an increasingly complex, globalised world. As the former Director-General of the Australian Security Intelligence Organisation (ASIO), observed:

The world in which we live is becoming ever more complex, more uncertain and, as a result of globalisation, more ‘connected’ than at any other time in history. The threats of terrorism, espionage and foreign interference recognise no borders. They are persistent, and their enduring nature means we cannot afford to rest on our successes. (ASIO 2019, pp. 3–4)

Australians expect that their governments would not permit foreign investment that could undermine Australia’s national security. In 2019, a plurality of respondents to the Lowy Institute poll (44 per cent) thought that ‘protecting Australians from foreign state intrusion’ should be the first priority when considering which companies to supply new technology into Australia (Kassam 2019, p. 30).

Currently, the Treasurer considers the details of FDI proposals under the ‘national interest’ test and can reject a proposal if there are national security concerns. These concerns can be raised during the screening process by agencies such as ASIO, Defence (including the Australian Signals Directorate), Home Affairs and others. Twenty-four other countries undertake

screening of foreign investment for national security reasons (UNCTAD 2019, pp. 92–93), including the United States (box 3.3).²² In June 2020, the Australian Government announced that it would be introducing a new ‘national security’ test for foreign investment that would not otherwise fall under the national interest screening process (box 2.2).

Box 3.3 National security screening in the US

The Committee on Foreign Investment in the United States (CFIUS) screens foreign investment for national security purposes. Approval by CFIUS is not mandatory before making an investment, although CFIUS has the power to commence an investigation and block a transaction or order divestment. Since 2018, mandatory reporting is required for transactions involving foreign governments acquiring a ‘substantial interest’ in a U.S. business that involves critical infrastructure, critical technologies or sensitive personal data. CFIUS’s ability to conduct a review is not confined by the size of the business or transaction.

CFIUS has ordered several divestments in recent years, including ordering a Chinese company to sell Grindr, a social networking app for gay, bi, trans and queer people, and ordering another Chinese company to divest from PatientsLikeMe, a health information sharing website for patients. While CFIUS does not publish reasons behind its decisions, media reporting cited concerns over the potential for blackmail of American officials or contractors for the Grindr decision (Sanger 2019). In 2012, CFIUS ordered a Chinese company to divest its interest in a wind farm because the company was building wind turbines next to a military site (Pace 2012).

CFIUS is chaired by the Treasury Secretary and Treasury receives, processes and coordinates applications. Other members of CFIUS are the heads of the Departments of Justice, Homeland Security, Commerce, Defence, State and Energy, and the Offices of the U.S. Trade Representative and Science and Technology Policy. The Director of National Intelligence and the Secretary of Labor are non-voting, ex-officio members.

The President is under no obligation to follow the recommendation of CFIUS, but, before prohibiting an investment, must conclude that other US laws are inadequate or inappropriate to protect national security and must have credible evidence that the foreign investment will impair national security (Congressional Research Service 2020, p. 21).

The nature of national security threats

Concerns about the impact of foreign investment on national security include three categories of ‘potential threats’ associated with FDI (Moran 2009) .

1. Dependency on foreign-controlled suppliers, creating opportunities for the supplier to delay, deny, or place conditions on the provision of crucial goods or services.
2. The transfer or leakage of sensitive national security technology or expertise to a foreign-controlled entity.

²² There has also been a recent global trend towards heightened restrictions. In 2018, the United Nations Conference on Trade and Development attributed its highest ever rate of new restrictions on foreign investment (at 34 per cent of all policy changes) to national security concerns (UNCTAD 2019, pp. 14, 84).

3. The creation of an additional channel for infiltration, espionage or sabotage by a foreign power.

More recently there have also been worries about the ownership of data on Australian citizens and residents (Uren 2019a). This includes not only data on national security personnel and operations, but also sensitive personal data about ordinary Australians, such as data held by social media, health, retail and financial services firms (Irvine 2019). The concern is that foreign governments could ‘build up profiles of Australian citizens’ (Kehoe 2019), from which they could then attempt to coerce or recruit key personnel (ASIO 2018; Cordero 2019; Uren 2018). ASIO has highlighted potential consequences, arguing that:

... foreign intelligence services could use the ownership and the access provided through foreign investment to influence key decision-makers in the Australian Government and/or manipulate suppliers and customers during business decisions. (ASIO 2018, p. 25)

China and national security

In recent years, national security concerns around inward FDI have tended to involve Chinese investors (box 3.4).

In the past, much of this concern was directed at state-owned enterprises (SOEs) or (occasionally) sovereign wealth funds, as they were often seen as an opaque arm of government, accused of investing for non-commercial or strategic reasons (Access Economics 2010, pp. 24–26; SERC 2009).

More recently, FDI by privately-owned Chinese companies has also generated consternation. In part, this is because Chinese laws (such as the 2017 National Intelligence Law, the 2015 National Security Law or the 2014 Counter-Espionage Law) can require *all* Chinese companies to ‘maintain national security’ or to support Chinese Government security activities (Bin 2019; Feng 2019; Girard 2019; Hoffman and Kania 2018). The American Enterprise Institute went so far as to state that ‘there is no difference in the control the Communist Party can exercise over private firms and SOEs ... [so] there is no justification to treat them differently with regard to national security’ (Scissors 2018, p. 8).

Concerns about Huawei — a private telecommunications company — are a case in point. In August 2018, the Australian Government indirectly prohibited Huawei’s involvement in the rollout of the 5G telecommunication network, due to fears about companies that are ‘subject to extrajudicial directions’ from the Chinese Government, creating risks of ‘unauthorised access or interference’ in the network (Fifield and Morrison 2018; Slezak and Bogle 2018).²³

²³ Work commissioned by Huawei indicated that, as one of the most competitive suppliers in the 5G market, there are significant costs to excluding Huawei (estimated at over \$2 billion), which will ultimately be borne by consumers (Frontier Economics 2018).

Box 3.4 **Some Chinese investment has attracted security concerns**

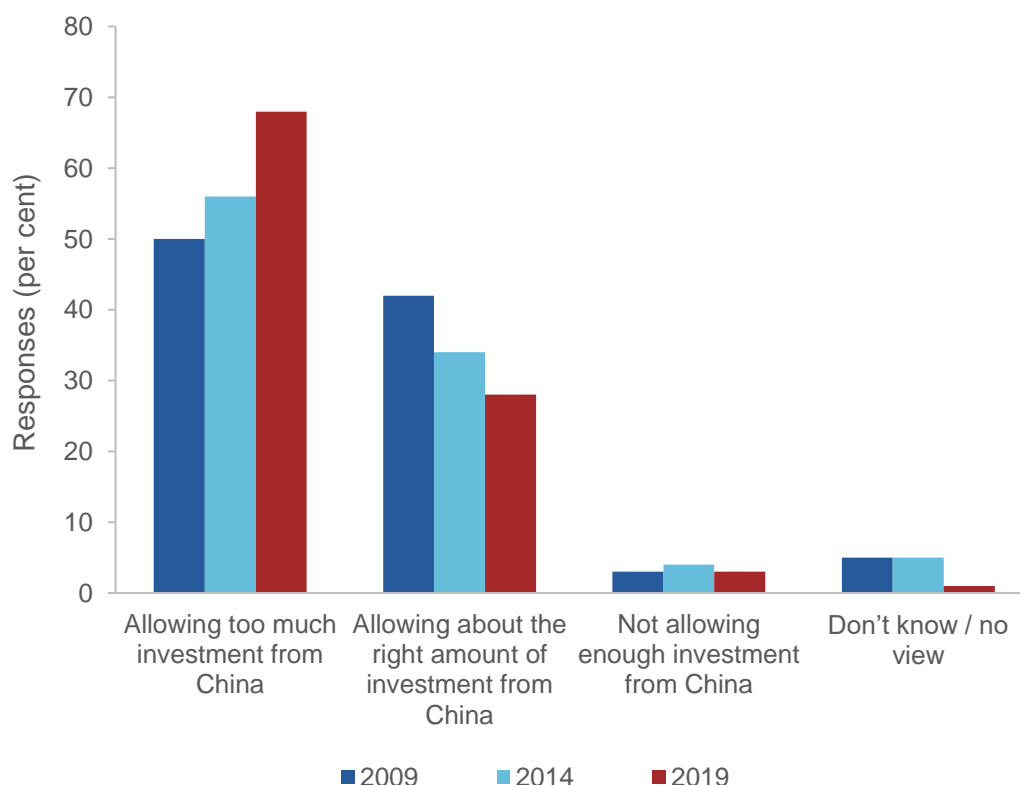
There are several recent examples of Chinese investment in Australia that have raised security concerns from FIRB or the broader national security community.

- There were objections from the United States in November 2015, when the NT Government sold a 99-year lease on the **Port of Darwin** to Landbridge, a private Chinese company. The concerns were attributed to the surveillance and espionage capabilities presented by the port's close proximity to Australian and United States defence facilities, as well as concerns about the strategic purpose of China's investment in the region as part of its Maritime Silk Road (Barnes and Jennings 2015; Jennings 2015; Zhang 2015).
 - Although FIRB was asked to look at the deal by the NT Government, the Australian Government had no authority to intervene, as an acquisition from a state/territory government was outside of its remit at that time. In response, the Government amended the Foreign Acquisitions and Takeovers Regulation 2015, allowing it to intervene in similar deals in the future (FIRB 2017a, p. 8; Walsh 2019).
- In 2016, the NSW Government attempted to sell 50.4 per cent of **Ausgrid** on a 99-year lease to the State Grid Corporation (a Chinese state-owned enterprise) and Cheung Kong Infrastructure Holdings (a private Hong Kong company). The sale was blocked by the Treasurer in August 2016 on national security grounds, reportedly because Ausgrid hosted infrastructure crucial to the joint Australia-US surveillance facility at Pine Gap, in the Northern Territory (FIRB 2018, p. 23; Hartcher 2018; Morrison 2016a).
- A bid for **OZ Minerals** in March 2009 by state-owned China Minmetals was initially rejected by the Treasurer, due to the inclusion of the Prominent Hill mine in South Australia, located in the Woomera Prohibited Area defence zone. The deal with China Minmetals proceeded in April 2009, after the mine was excluded from the sale (OZ Minerals 2009; *Reuters* 2009).

There has also been a broad increase in opposition to Chinese investment among the public. The Lowy Institute's poll found that 68 per cent of respondents thought that Australia allows too much investment from China (figure 3.4). A different poll found the same proportion of Sydney residents were concerned about growing Chinese investment in Australia in 2015 (Rogers, Wong and Nelson 2017).

However, it is unclear whether this opposition is due to national security concerns, rising house prices (section 3.5), or the rapid growth in Chinese investment over the past decade. Australia has previously seen community opposition to FDI during periods of rapid increase in investment from specific countries — the United States in the 1960s and Japan in the 1980s (Laurenceson 2016) — but opposition eventually gave way to normalisation. On the other hand, this is the first period of rapid increase in investment from a country that is not a democratic country, nor a military ally, which 'adds an additional degree of complexity' (Access Economics 2010, pp. 31–32).

Figure 3.4 Discontent with Chinese investment has risen
Poll responses on Australian policy towards Chinese investment, 2009–2019



Source: Kassam (2019, p. 26).

Security threats arise in many ways, not only from foreign investors

Although a change in ownership may create national security risks, the likelihood and magnitude of this threat can be difficult to determine. One problem is that none of the threats to national security outlined above *require* foreign investment. Indeed, in some cases ‘foreign ownership would seem to be an inefficient and costly way of acquiring these capabilities’ (Kirchner and Mondschein 2018, p. 7). For example:

- China’s dominance of rare earth mining and processing is generating anxiety, over fears it could make crucial supplies of advanced electronics vulnerable to disruption through export restrictions on Australian-owned firms (Coorey and Kehoe 2019; Uren 2019b).
- The *Defence Trade Controls Act 2012* restricts the export of sensitive technologies (even dual-use technologies with no current military applications) to avoid them being transferred or leaked (through reverse-engineering) to a foreign actor, even where the exporter is Australian-owned (Thom 2018).

-
- Infiltration, espionage or sabotage can occur through the employees and supply chains (from imports, exports or outsourcing arrangements) of Australian-owned businesses, as well as unconnected agents — for example, the former Chief of the Defence Force observed that ‘I can sit at the fish and chip shop on the wharf at the moment in Darwin and watch ships come and go, regardless of who owns it [the port]’ (Binskin 2015).
 - Personal data held by Australian-owned companies can be just as vulnerable to hacks, breaches and leaks through inadequate security or data protection as data held by foreign-owned companies.²⁴

3.4 Multinational tax avoidance

The global output and profitability of multinationals cannot easily be ascribed to operations in a particular country. Some multinational investors are able to use complex cross-border legal structures to exploit inconsistencies between tax regimes, allowing profits made in relatively high-tax countries (like Australia) to be booked in low-tax (or no-tax) jurisdictions elsewhere (known as ‘base erosion and profit shifting’ or BEPS). There are a number of common mechanisms used to do this, including:

- thin capitalisation (‘allocating proportionally more debt to group companies in high-tax countries than in low-tax countries’)
- transfer pricing (‘having group companies in high-tax countries undercharge for sales, or overpay for purchases, to or from group companies in low-tax countries’)
- intangible asset rents (‘paying royalties from group companies in high-tax countries ... for the use of intangibles such as brand names’) (Kelly and Graziani 2004, p. 39).

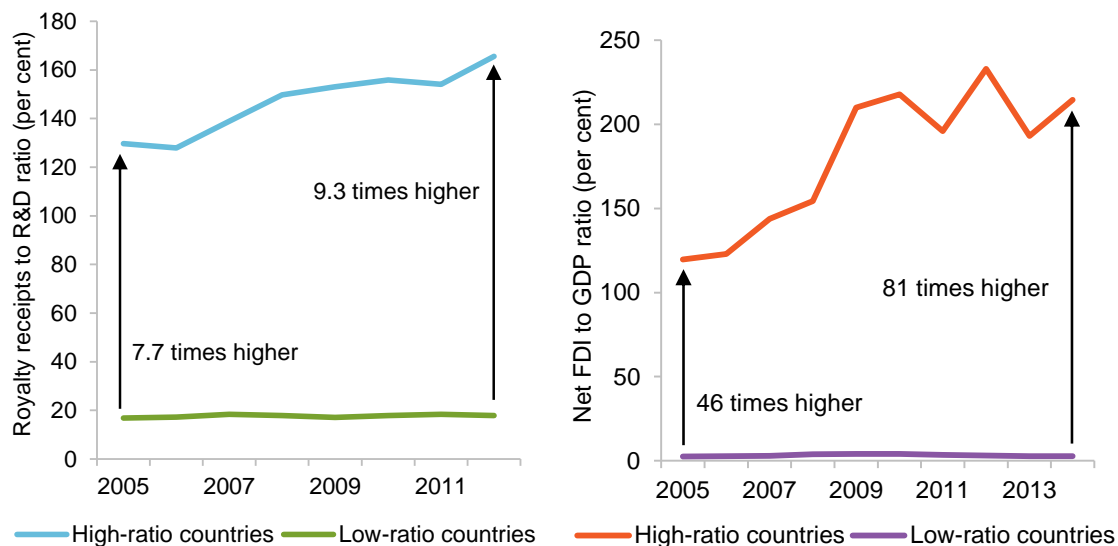
In partnership with the Group of 20 (G20), the OECD has undertaken extensive research on BEPS. Although limitations on available data constrain analysis, the OECD’s research has found that:

- profit rates of multinational affiliates in low-tax countries are twice as high, on average, as their group’s worldwide profit rates
- the ratio of royalties received to research and development spending in a group of low-tax countries was six times higher than the average ratio for other countries, and increased three-fold between 2009 and 2012 (figure 3.5)
- FDI is increasingly concentrated, as countries with high net FDI to GDP ratios in 2005 saw increased ratios by 2012, up to 99 times higher than for other countries (figure 3.5)
- tax revenue losses from BEPS are estimated at 4–10 per cent of global corporate income tax revenue (or US\$100 billion to US\$240 billion)

²⁴ In the 12 months to 31 March 2019, there were 964 instances of data breaches from Australian companies (domestic and foreign owned), of which 60 per cent were malicious or criminal attacks (OAIC 2019, p. 4).

- effective tax rates paid by large multinationals are 4 to 8.5 percentage points lower than similar domestic-only enterprises (OECD 2015, pp. 15–16).

Figure 3.5 Foreign investment and royalty receipts are becoming more geographically concentrated^a



^a Both indicators are circumstantial evidence of tax minimisation. The left hand figure shows that countries that already had high royalty to R&D ratios (an indicator that IP developed elsewhere is being parked in that country, presumably for tax reasons) have seen these ratios increase. The right hand figure shows that countries that had high net FDI to GDP ratios (an indicator that they host assets without corresponding real business activities, presumably for tax reasons) have also seen these ratios increase.

Source: OECD (2015, pp. 51, 62), updated from OECD (pers. comm. 19 March 2020).

Overall, when the results are combined ‘they confirm the existence of BEPS, and its continued increase in scale in recent years’ (OECD 2015, p. 15), with the OECD observing there is:

... a perception that the domestic and international rules on the taxation of cross-border profits are now broken and that taxes are only paid by the naïve. (OECD 2013, p. 13)

In contrast to multinational competitors, wholly-domestic companies are (by definition) not linked to any other jurisdiction, so cannot so easily shift profits overseas. Even Australian-owned multinationals that *do* operate overseas have more limited incentives to engage in BEPS, due to Australia’s dividend imputation system (Kelly and Graziani 2004, p. 40).

Minimising minimisation — anti-avoidance provisions, BEPS steps and tax conditions

To reduce the incidence of multinational tax avoidance, the Australian Taxation Office (ATO) has long had special anti-avoidance powers (Vernon et al. 1965a, p. 288). More recently, the Government has strengthened the ATO’s compliance regime, providing it with

additional powers and resources, including a new Tax Avoidance Taskforce, amendments to the ‘general anti-avoidance rule’, introduction of the ‘multinational anti-avoidance law’, higher non-compliance penalties and added whistleblower protections (ATO 2018; Treasury 2019).

Due to the cross-border nature of multinational tax avoidance, international coordination and cooperation is also necessary to close or reduce gaps, inconsistencies and loopholes between tax jurisdictions. This cooperation has been assisted by the OECD’s BEPS program, which involves over 130 countries ‘collaborating to put an end to tax avoidance strategies that exploit gaps and mismatches in tax rules to avoid paying tax’ (OECD 2019a).

Increasingly, FIRB approvals are being used as a tool to prevent tax avoidance by foreign investors. FIRB has increased its use of ‘tax conditions’ attached to investment approvals (chapter 2), applied case-by-case, based on an ATO assessment of risk.

3.5 Residential real estate and agriculture

Many Australians express concerns about the effects of foreigners purchasing Australian residential real estate (especially in Sydney and Melbourne) and farming land (including investment in the broader agriculture sector).

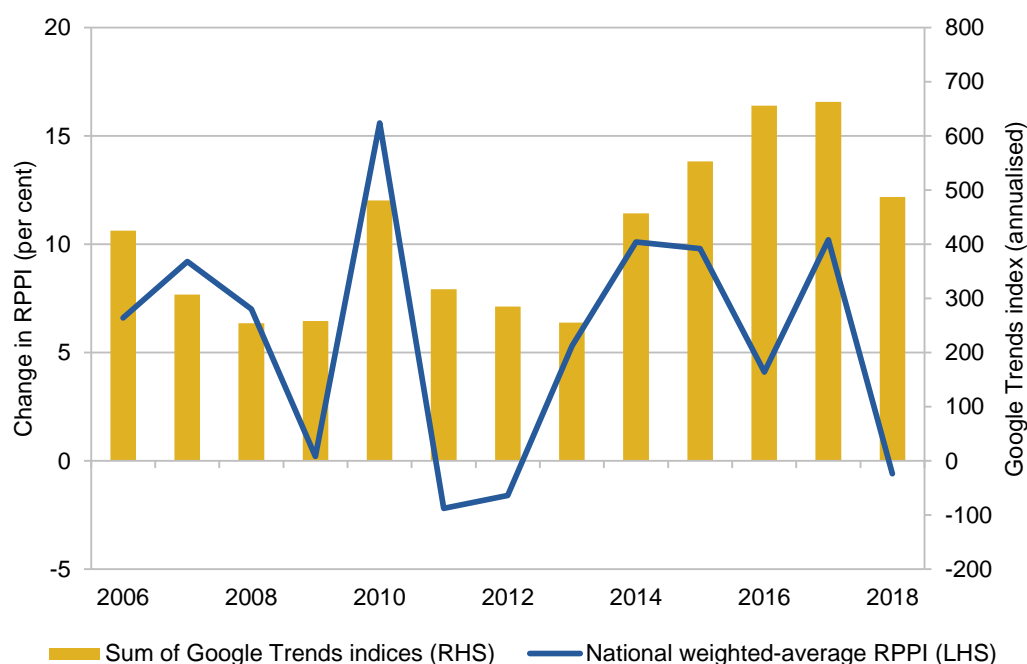
Flogging the house? Residential real estate and foreign investment

Although Australians have long been wary of foreign purchases of residential property (Uren 2015, pp. 157–158), more recent concerns have been directed at Chinese investment in Australian real estate (Carey 2019; Frost 2019). In 2015, the Lowy Institute found that 70 per cent of respondents believed that there was too much investment in residential real estate from China, compared to 34 per cent for real estate investment from either the US or Europe (Oliver 2015, p. 22). Typically, the concerns are due to a belief that foreign investors are increasing prices for prospective Australian buyers, pushing Australian residents out of the property market (ACIL Allen Consulting 2017, p. 39; Corderoy 2017; HRSCE 2014).

Naturally then, consternation about foreign investors tends to become louder during periods of rapid house price growth. Much of the recent wave of concerns (approximated by trends in relevant Google web searches in figure 3.6) coincided with the sustained growth in property prices between 2013 and 2017. In one poll, 81 per cent of respondents thought that overseas investors were a key factor driving Sydney’s house price boom (McCrindle Research 2015, p. 6).²⁵

²⁵ Another Sydney-based poll found that: 78 per cent thought that foreign investment was driving up local house prices; 65 per cent believed that foreign investors were among the top three determinants of house prices in Sydney’s housing market; 55 per cent of respondents disagreed that foreign investors should be able to purchase property in Sydney; and 49 per cent disagreed with the statement ‘I welcome Chinese foreign investors buying properties in my suburb’ (Rogers, Wong and Nelson 2017).

Figure 3.6 Property price booms tend to coincide with worries about foreign investors ...
 Change in residential property price index (RPPI)^a and Google Trends indices on foreign investment sentiment^b, 2005-2006 to 2017-2018



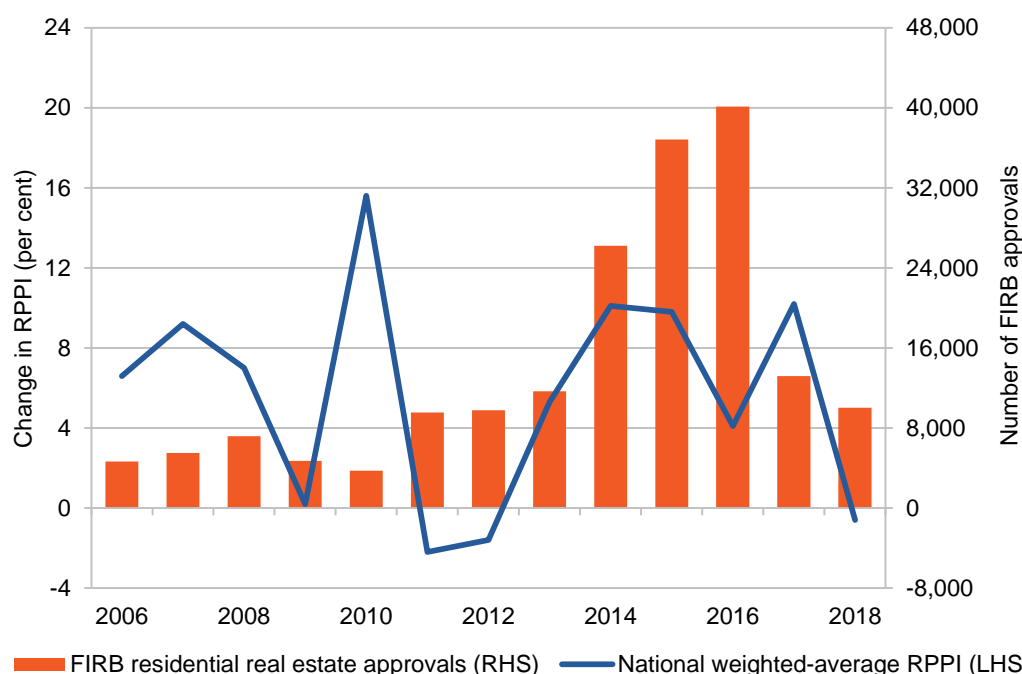
^a Changes in RPPI measured from differences in June quarters. ^b Google Trends index based on monthly Australian web searches for selected terms ('Chinese property investors', 'Chinese investors', 'Chinese buyers', 'foreign buyers', 'foreign investors') and calculated as a sum of annualised indices.

Sources: ABS, *Residential Property Price Indexes: Eight Capital Cities*, Jun 2019, cat. no. 6416.0 and Google Trends (www.trends.google.com).

Critics of foreign investment are correct to observe that the timing of the investment coincided with the most recent house price boom. The number of FIRB residential real estate approvals quadrupled during the latest boom (figure 3.7), from less than 10 000 in 2011-12 to over 40 000 in 2015-16, with most of the growth in foreign investment applications appearing to have come from China (figure 3.8). Application numbers then fell to about 13 000 in 2016-17, likely due in part to the introduction of a range of new federal and state taxes on foreign property investors and the introduction of fees on FIRB applications in December 2015 (chapter 2).

Figure 3.7 ... while foreign interest also coincided with the last boom

Changes in residential property price index (RPPI)^a and FIRB approvals for residential real estate^b, 2005-2006 to 2017-2018

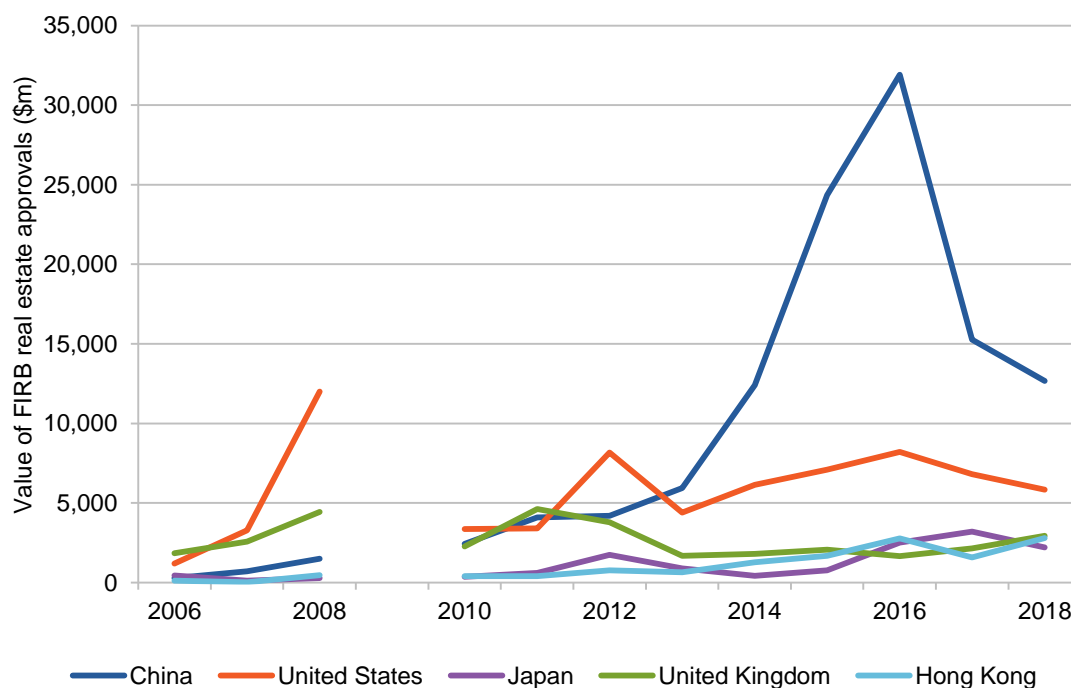


^a Changes in RPPI measured from differences in June quarters. ^b Annual FIRB approvals include both 'developed' and 'for development' properties.

Sources: ABS, *Residential Property Price Indexes: Eight Capital Cities*, Jun 2019, cat. no. 6416.0 and FIRB annual reports, various years.

Figure 3.8 Recent interest in real estate is particularly strong among Chinese investors

FIRB approvals^a for the entire real estate sector^b, by country of origin, 2005-2006 to 2017-2018



^a Data for the 2008-09 financial year is missing. ^b Covering FIRB approvals for both residential and commercial real estate.

Source: FIRB annual reports, various years.

The effect of foreign investment on house prices is difficult to quantify

The extent to which foreign investment caused part of this price increase is unclear. Foreign investors only ever make up a minority of housing market demand (box 3.5).²⁶ Moreover, they are restricted to new developments that add to the housing stock, often preferring high-density apartments in inner Sydney and Melbourne (Gauder, Houssard and Orsmond 2014, p. 14).

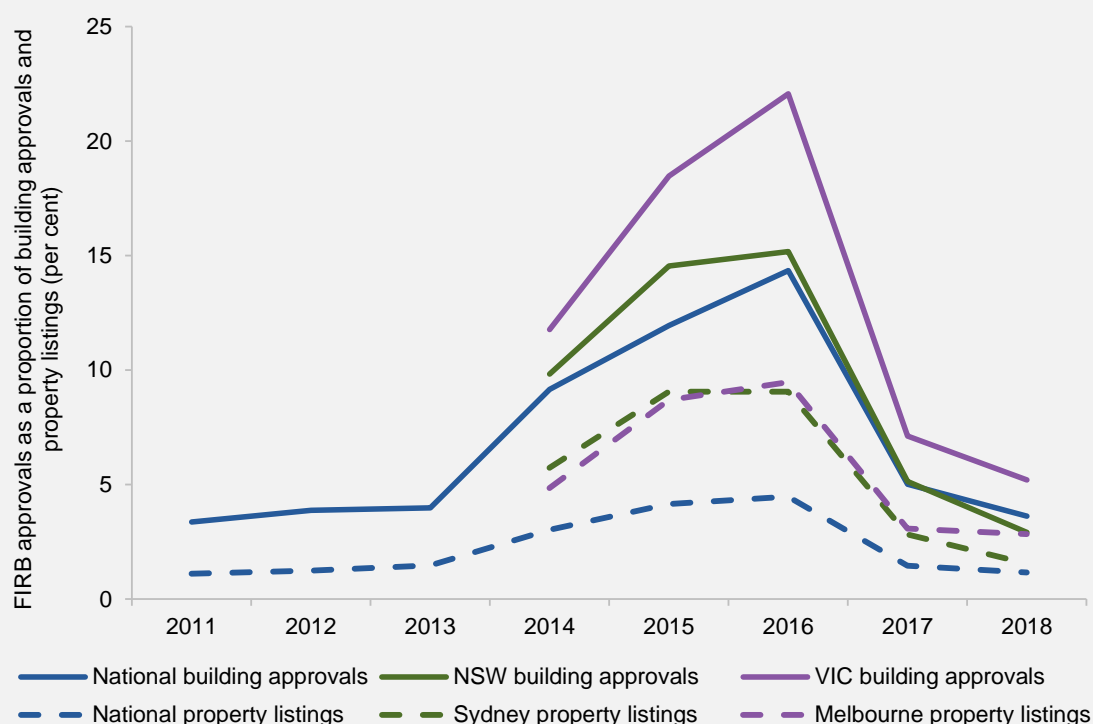
²⁶ Community perceptions about the extent of foreign investment in real estate may also reflect confusion about the nationality of purchasers given Australia's multicultural population. This is likely one reason why only 16 per cent of ATO investigations into unlawful real estate purchase that start from community information (around one-fifth of all investigations) led to the discovery of a breach in 2017-18.

Box 3.5 Foreign investment as a share of housing market demand

It is difficult to measure foreign investment as a proportion of the residential real estate. Although the best indicator of foreign investment in real estate is the number of FIRB approvals, this data has limitations — some investors may seek approvals that ultimately do not proceed.

- Nationwide, FIRB approvals^a for new housing ('for development' approvals) grew to nearly 15 per cent of all building approvals in 2015-16^b, with approvals in Victoria reaching over 22 per cent in the same year (figure below).
- As a proportion of new property listings, FIRB approvals for residential real estate (both 'existing' and 'for development') peaked at 4.5 per cent in 2015-16^c, with rates in the Sydney and Melbourne property markets about double this level (figure below).
- The National Australia Bank's quarterly survey of property industry professionals estimates the share of foreign buyers reached a peak in 2015 of about 16 per cent for new homes and 9 per cent for established properties (for temporary residents), but has since fallen.

Overall, the data suggests the residential real estate market has always been dominated by Australian purchasers rather than foreign investors.



^a State-level data for FIRB approvals are not available prior to 2013-14. ^b Measured as FIRB approvals 'for development' as a proportion of total building approvals. ^c Measured as all FIRB approvals (at a state level for NSW and VIC) as a proportion of monthly property listings under 30 days old (nation-wide and in Sydney and Melbourne). This figure is inflated by the assumption that all state-level approvals in NSW and Victoria were reflected in demand for Sydney and Melbourne properties.

Sources: ABS, *Building Approvals*, Sep 2019, cat. no. 8731.0; FIRB annual reports, various years; NAB (2019); SQM Research (2019).

The strength of the relationship between foreign investment and house price movements depends upon how rapidly supply, particularly of apartments, can respond to surges in

demand. Here there is some cause for concern. The Commission has previously found that ‘supply lags are an inherent feature of land development and dwelling construction’ (PC 2004, p. 124). The Reserve Bank of Australia (RBA) has also described housing supply as ‘inherently sluggish’, especially in the short term as natural and artificial constraints on development limit construction, including time lags, land availability near areas of demand, zoning and planning regulatory restrictions and resistance to new development from existing residents (Gauder, Houssard and Orsmond 2014, p. 15).

Overall, the evidence to date suggests that the effect of additional demand from foreign investors is likely to be modest (box 3.6). For example, the RBA found that although ‘foreign residential demand has probably resulted in an increase in the supply of dwellings in Australia by more than would otherwise have been the case’, it also concluded that the supply constraints mean that ‘some of the increase in foreign demand for housing may have spilled over into higher prices’ (Gauder, Houssard and Orsmond 2014, p. 11).

Ultimately, concerns about rising prices in residential real estate, whether associated with foreign or domestic demand, are best addressed through policies that target the fundamental factors affecting prices, particularly constraints on the supply of housing. For instance, the Commission has previously flagged a range of initiatives in land use, planning and zoning that would deliver benefits from reduced costs associated with development delays, including the holding costs of land, documentation and development risks (PC 2017b, p. 37).

Box 3.6 Evidence linking foreign investors and house price growth

Establishing a link between property price growth and foreign investment is hindered by the parlous state of publicly available data (discussed in chapter 1), which means that — at best — the magnitude of the relationship is ambiguous. There is little data on *actual* foreign investment in residential real estate, as the Australian Bureau of Statistics (ABS) data do not capture transactions below \$20 million. More complete data is collected by FIRB on approvals, but not on *realised* investment, and only limited time series and geographic detail are published.

Analysis from Treasury (Wokker and Swieringa 2016) supported the view that the house price effects of foreign investment in Australia are fairly limited. The analysis modelled property price growth between 2010 and 2015 against foreign investment application data at a postcode level, finding that an additional application was associated with a statistically significant (but economically negligible) increase in price growth in Sydney and Melbourne, worth about \$80 to \$122 per quarter (or less than one per cent of the average quarterly increase in property prices).

Overseas, separate studies used economic shocks in foreign countries (as an instrumental variable) to determine that additional foreign investment has probably contributed to recent significant house price growth in London (Badarinza and Ramadorai 2018) and across England and Wales (Sa 2016).

Selling the farm? Agriculture and foreign investment

Australia's relationship to foreign investment in the agricultural sector is complex.

Many farmers recognise the vital historical role that foreign investment has played in developing and expanding the agriculture sector. The National Farmer's Federation, for example, has stated that it:

... supports foreign investment in Australian agriculture and recognises the important role it has and will continue to play in a vibrant agricultural supply chain. To date, foreign investment has proven to be overwhelmingly positive for Australian farmers and regional communities. It has delivered significant amounts of capital into our production systems at a time when finance from the banks has been harder to access. This capital has improved our efficiency and ensured that our farmers can continue to compete in a highly distorted global marketplace for agricultural commodities. (NFF 2016, p. 31)

On the other hand, public opinion is generally opposed to foreign investment in agriculture. In 2016, the Lowy Institute found that 87 per cent of respondents were against allowing foreign companies to buy Australian farmland (Oliver 2016, p. 26). Similarly, the Australian Broadcasting Corporation found that 80 per cent of respondents think the government should restrict foreign ownership of Australian agricultural land (Jasper, Felton-Taylor and Vidot 2016). And the 2014 Lowy Institute poll found that 60 per cent of respondents were against allowing foreign companies to invest in the agriculture sector (Oliver 2014, p. 24). Some of the commonly-cited reasons for this mindset are discussed in box 3.7.

Box 3.7 Common objections to foreign ownership in agriculture

The Commission has previously suggested that there are a range of public perceptions that contribute to the aversion towards foreign investment in agriculture. None are well-supported by evidence.

- *Reducing Australia's food security* — Australia produces more than twice the amount of food it consumes, while all farms are still subject to international price pressures.
- *Creating a 'land grab' and loss of control over prime agricultural land* (as a scarce non-renewable resource) — land use is regulated, and the Australian Government maintains sovereign control over all land use and business activities.
- *Reducing employment in local and rural communities* (as foreign labour may displace Australian jobs) — locals are more likely to have the necessary skills, knowledge and experience, providing them with a competitive edge, while many Australian-owned farms already rely on temporary migrants due to labour shortages.
- *Not keeping agricultural companies in Australian hands* (particularly iconic companies) — many agricultural 'icons' are already foreign-owned, while foreign investors often rescue struggling domestic businesses that are about to collapse.

Source: PC (2016b, p. 556).

Yet the value of foreign investment in Australian agriculture is relatively small. In December 2018, the stock of FDI in Australian agriculture, forestry and fishing was just \$3.2 billion,

only 0.3 per cent of total inward FDI.²⁷ And in 2017-18, FIRB screened and approved 201 investment applications for the agriculture, forestry and fishing industry, worth \$7.9 billion (or less than 5 per cent of all decisions by value) (FIRB 2019, p. 30).

Foreign holdings of agricultural land are also limited (figure 3.9). In June 2018, foreign interests covered only 13.4 per cent of Australia's agricultural land (with a quarter of this apportioned to Australian co-owners). The largest foreign owners are the United Kingdom (2.6 per cent) and China (2.3 per cent), and most foreign-held land (86 per cent) is used for livestock (ATO 2019b). Similarly, foreign ownership of water entitlements is also limited, at 10.4 per cent in June 2018 (9.4 per cent within the Murray-Darling Basin). Most of these entitlements are used in the agriculture (66.5 per cent) and mining (26.3 per cent) industries (ATO 2019c).

Nonetheless, the public's strong opposition to foreign investment in agriculture is reflected in recent policy changes (appendix C). In 2015, the Government tightened the screening thresholds for agriculture (from \$252 million to \$15 million for agricultural land or \$55 million for agribusiness), and created a register of foreign owned agricultural land, increasing reporting requirements. During 2016, the Government's decisions on the sale of Australia's biggest agricultural landowner, S. Kidman and Co., also reflected many of the community's worries (box 3.8).

These policy changes increased the restrictiveness of Australia's screening of foreign investment in agriculture, creating long-term risks for the sector (discussed in chapter 4).

Box 3.8 The unsuccessful bid for S. Kidman and Co.

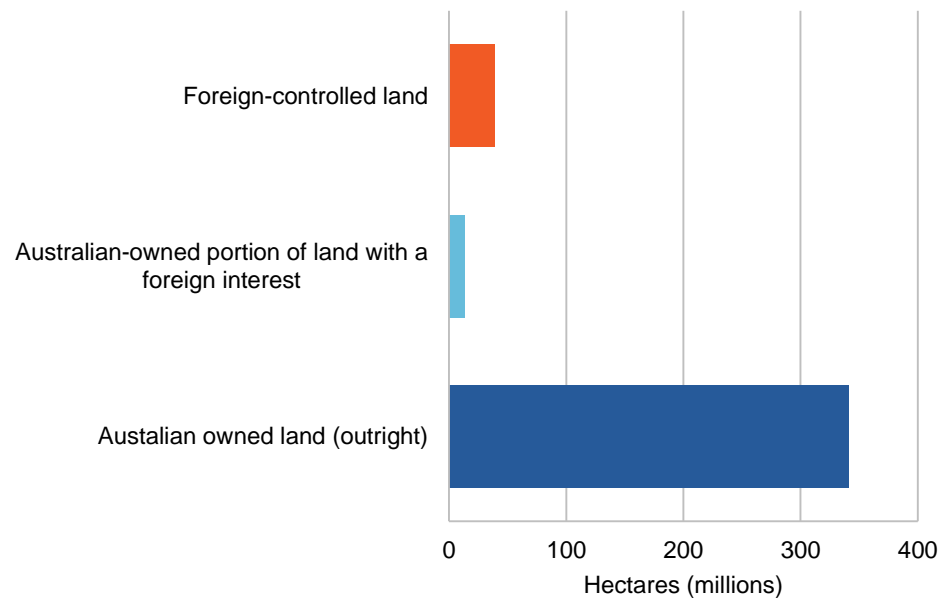
S. Kidman and Co. is one of Australia's largest beef producers, with a herd of several hundred thousand cattle and pastoral leases covering about 80 000 square kilometres in four states and territories (S. Kidman and Co. 2019).

In November 2015, initial bids by foreign investors for the purchase of S. Kidman and Co. and its Anna Creek cattle station (located within the Woomera Prohibited Area defence zone) were pre-emptively blocked by the Treasurer on national security grounds (Morrison 2015b). A revised bid of \$370 million (excluding Anna Creek station) by a joint venture between Chinese entity Dakang Australia Holdings and domestic firm Australian Rural Capital was then rejected by the Treasurer in April 2016, due to ongoing concerns about the size of the company's land holdings, at over 2 per cent of Australia's agricultural land (ABC Rural 2016; Morrison 2016b).

In October 2016, S. Kidman and Co. (excluding Anna Creek station) was eventually sold for \$365 million, with the majority held by Australia's Hancock Beef, and Chinese entity Shanghai CRED Real Estate Stock Co. in a minority stake, after the Treasurer 'was satisfied that Australian parties had sufficient opportunity to participate in the new sales process' (FIRB 2017a, pp. 24–25; Schwartz and Waldhuter 2016).

²⁷ Foreign investment is also likely in the food manufacturing subsector, but this is not separated out from the \$108 billion of FDI in the manufacturing sector as a whole (ABS 2019b, table 15).

Figure 3.9 This land is your land, this land is my land
Ownership of Australian agricultural land, as at June 2018



Source: ATO (2019b).

4 Getting the balance right

Key points

- Australia's foreign investment framework seeks to balance the economic benefits that foreign investment can bring against the risks, and to maintain community confidence that foreign investment is in the national interest.
 - This balance has shifted over the past decade, as national security threats and aggressive tax minimisation practices have become more prominent.
 - In the process, the role of the Foreign Investment Review Board (FIRB) has evolved into something more akin to a regulator, yet its powers and institutional arrangements have changed little.
- The policy framework involves screening foreign investment applications against a broad 'national interest' test, with the Treasurer as decision maker. Some aspects of the current policy regime work well and others could be improved.
 - On the positive side, the design and vesting of responsibility with the Treasurer for administering the national interest test is working well. The test weighs up not just the costs, but also the benefits from foreign investment, and it is framed as a 'negative test' — proposed investments are only rejected if *contrary* to the national interest — limiting the risk of refusing projects that are in the national interest. These features should be retained.
 - On the negative side, there are unnecessary costs associated with the design of the national interest test, the use and enforcement of conditions, and poor transparency.
- The national interest test is very broad and lacks clarity around how it is interpreted.
 - Tighter policy guidance should be provided around issues to be considered in screening.
 - The breadth of the national interest test should be narrowed to exclude those risks that can be mitigated through national regulations (such as competition).
- Attaching conditions to foreign investment approvals with limited enforcement capability provides only a limited means to mitigate risks and foster community confidence.
 - National laws and regulations, with purpose-built and adequately-resourced regulators (such as the Australian Taxation Office or the Critical Infrastructure Centre), provide a more flexible risk management capability and, where available, should be preferred.
 - If conditional approvals remain prevalent, consideration needs to be given to whether FIRB's monitoring resources and enforcement toolkit are adequate to ensure compliance.
- There is scope to improve investor certainty and transparency by:
 - routinely publishing reasons for decisions to block proposals, recognising that national security and commercial confidentiality may limit the detail or timing of publication
 - publishing more detailed information on the timeliness of decisions each year and giving early advice to investors where standard timelines will not be met
 - setting application fees for screening foreign investment proposals at the level that recovers the costs of administration, without under- or over-charging.

Australia's foreign investment framework seeks to balance the economic benefits that foreign investment can bring against the risks, as well as to maintain community confidence that foreign investment is in the national interest. This balance has shifted over the past decade, as national security threats and aggressive tax minimisation practices have become more prominent. Incremental changes have been made to foreign investment policy and its administration (appendix C). In the process, the role of the Foreign Investment Review Board (FIRB) has evolved into something more akin to a regulator, which was recently acknowledged by the Australian Government when it announced a range of enhanced compliance and enforcement powers.

This chapter takes a step back and examines whether Australia's foreign investment policy could achieve its goals at lower cost. To do this, it considers whether the policy framework and its administration follow leading regulatory practice. The chapter draws on four well established principles of leading regulatory practice and guidelines for investment policies (in relation to national security) published by the Organisation for Economic Cooperation and Development. These relate to:

- non-discrimination — treating similarly situated investors in the same way
- transparency and predictability — having codified and published guidelines and regulations; maintaining procedural fairness, including adhering to strict timelines and protecting commercially sensitive information; and disclosing policy actions and decisions
- regulatory proportionality — restrictions (or conditions) on investment should not be greater than needed to achieve their goals (for example, protect national security) and should be avoided when other measures are better suited to addressing concerns
- accountability — including parliamentary oversight, judicial review, regulatory impact statements and requiring important decisions be taken at high government levels. (OECD 2009, pp. 3–4)

Against the above principles, the chapter considers the design of the national interest test (section 4.1), the use and enforcement of approval conditions (section 4.2) and the scope to improve certainty and transparency (section 4.3). In each section it identifies scope to improve on current practices, and overall to reach a more coherent and even-handed regulatory framework, with conclusions summarised in section 4.4.

4.1 Design of the national interest test

The design of the screening framework, including the definition and nature of the national interest test and the governance arrangements shaping decision makers' powers are critical to good investment outcomes. The current framework involves notification and screening procedures based on a broad national interest test, with the Treasurer as decision maker.

A negative or a positive test?

The current national interest test is a ‘negative’ test, which places the onus of proof on the Government to approve all foreign investment applications *unless* it can determine that a proposed investment is against the national interest. This is a fairly high bar and few investment applications are blocked outright (chapter 2). Some countries, including New Zealand, reverse the onus of proof — a ‘positive’ test — with the investor making the case for why the investment is in the national interest.

There are good reasons for a negative test. Most importantly, it does not require the government to codify the national interest, which is intrinsically difficult to do, since the concept is ambiguous and unforeseen risks can arise suddenly. A negative test, therefore, gives the Treasurer some discretion on how to interpret the national interest and flexibility to quickly respond to new concerns, or to avoid blocking investments on grounds that were once relevant, but no longer are. It also constrains compliance costs.

In contrast, a positive test would likely require a definition of the national interest in the *Foreign Acquisitions and Takeovers Act 1975*. While this would increase the transparency of Australia’s foreign investment policy, it would also come with risks of false positives. The Government’s foreign investment policy argues that ‘rigid laws that prohibit a class of investments too often also stop valuable investments’ (Australian Government 2019, p. 1). Treasury has also noted that prescriptive laws would need ongoing amendment (SERC 2016, p. 8).

The breadth of the test

Another factor complicating interpretation of the national interest test is its breadth.

National security, economic, community, competition and regulatory concerns, as well as the character of the investor, all feature in the policy guidelines (chapter 2). One prominent commentator contends that the ‘undefined and open-ended nature of the national interest test places no real burden on the Commonwealth’ to demonstrate that its decisions are consistent with the national interest (Kirchner 2008, p. 17). This unrestrained power, Kirchner (2008, p. 17) argues, adds to businesses’ uncertainty and may make decisions more susceptible to lobbying, which in some cases could be contrary to the national interest.

Kirchner (2008, pp. 16–17) has suggested allowing the Government to block investments only on the narrower basis of threats to national security. There is some merit in this ‘small garden, high wall’ interpretation of the national interest. The economic and competition considerations in the national interest test are arguably redundant or duplicative. There are generally no economic grounds for restricting investment merely because the prospective owner is foreign, while concerns about competition impacts are better dealt with through antitrust laws and regulations in the same as for any Australian investor or business.

Among the screening criteria, national security is central to the tests used in a number of other countries. Unlike the Australian regime, these generally allow investments to be

blocked (or divestiture to be forced) where national security threats are present, regardless of the value of the investment. For example, a small acquisition of a company holding sensitive personal data could be blocked.

- The President may block an investment that ‘threatens to impair the national security of the United States’, where there is credible evidence that the foreign-controlled business may take such actions and other laws are inadequate or inappropriate to protect the national security (Congressional Research Service 2020, p. 21). No transaction value threshold applies.
- Canadian legislation was amended in 2009 to introduce a separate national security review, in addition to a net benefit review. National security reviews may be undertaken regardless of the size of the transaction or the extent of the interest being acquired, unlike net benefit reviews (Koch 2018, pp. 40–41).
- The United Kingdom Government has indicated an intent to introduce legislation allowing it to block transactions for national security reasons, regardless of the business size (U.K. Government 2019).
- The New Zealand Government has indicated it intends to introduce an additional test as a backstop (in addition to the current net benefits test) to address national security concerns. The test will apply to investments made by foreign governments (or associates), in sensitive sectors or where there is a national security risk, regardless of the size of the investment (Parker 2019).

It is noteworthy that in most of the countries cited above, their governments have not narrowed the scope of the national interest test, but simply split the process into multiple tests. That in itself would not address the lack of clarity linked to the breadth of the national interest test and may inadvertently give less weight to the benefits of foreign investment. Rather than split the test or codify the national interest in legislation, a more appropriate response may be to develop clearer and more detailed policy guidance (covered in section 4.3). This was the conclusion reached by the Senate Economic References Committee:

The committee recognises the validity in retaining the broad and unlegislated character in respect of the national interest test. Yet such flexibility must be balanced by a clear, consistent and rigorous procedure for assessment that is publicly accountable. In short, flexibility should not come at the expense of both consistency and transparency. (SERC 2016, p. 51)

Indeed, a significant advantage of the current national interest test is that it weighs up not just the costs, but also the benefits. A low level of national security risk need not stop an investment that brings economic and other benefits to the country. The relevant question for FIRB’s review is the extent to which allowing the investment increases the likelihood of security risks over and above the pre-existing risk in the absence of any foreign investment (chapter 3). It must also consider if the use of conditions (section 4.2) can further narrow the downside risks. For most projects, the costs of ‘getting it wrong’ from a security point of view are manageable, and options to lower the risk need to be assessed against the costs of an overly restrictive foreign investment regime.

In June 2020 the Australian Government announced that it would be creating a new ‘national security’ test for foreign investment in sensitive sectors that would not otherwise be screened under the national interest test (because the proposed investment would be under the screening threshold). This would mean the Government could review all foreign investment in sensitive sectors on national security grounds, regardless of its value. In some regards, the new test risks having the same drawbacks as the split processes overseas, in that it could give less weighting to the economic benefits the investment could bring.

The Treasurer is the appropriate decision maker

Getting the balance right between economic benefits and national security risks is far from straightforward. As in other areas of security policy, or risk management more generally, many trade-offs and judgements are required. This raises the question of who is the appropriate decision maker. Under the current legislated national interest test, FIRB (with a secretariat within the Treasury) advises the Treasurer, who then makes the decision. (The new national security test would also be decided by the Treasurer.)

This arrangement has been in place since the start of investment screening, and has adapted over recent years in response to a changing risk profile, and the increasing influence of national security and intelligence agencies in foreign investment decisions (Jennings 2017; Uren 2019a).

However, the same commentators that favour a narrower national security test often go further. They argue that the decision maker should be the National Security Committee (NSC) of Cabinet, rather than the Treasurer, on the grounds that the NSC would bring greater expertise in national security matters (Jennings 2017; Kirchner and Mondschein 2018, p. 23).

While there is scope to narrow the issues considered in forming a judgement about the national interest (for example, removing competition), confining the focus solely to national security would risk undervaluing or ignoring the benefits from foreign investment. Moreover, the costs of denying a potentially valuable investment where there is no genuine security threat are diffuse and subtle, and will rarely be possible to observe, thus potentially perpetuating the cost.

In sum, the Treasurer deciding what is in the national interest on the basis of advice from FIRB remains an appropriate model for screening foreign investment. But there is scope, as outlined in the following sections, to improve administrative arrangements and to lower compliance costs borne by foreign investors.

4.2 Too many conditions are being imposed

The use of conditional approvals by FIRB is relatively common and has been growing in recent years (chapter 2). The increased prevalence of conditional approvals raises questions about their effectiveness and the overlap with other regulations and their enforcement.

Setting conditions

Conditional approvals provide a means to mitigate risks sufficiently to allow some foreign investments that may otherwise be blocked.

However, concerns about foreign investment can also be addressed through national regulations, such as tax and competition law, environmental regulation and so forth (chapter 3). Indeed, the effectiveness of conditions in mitigating risk is limited, compared with sound regulation:

- While conditions can be imposed at the point of investment approval, national security and taxation risks evolve over time through changes in the nature of the business, technology and geopolitics. Conditions set at the point of the transaction become less effective in mitigating risks over time.
- Only foreign acquisitions with values above specific thresholds are subject to FIRB screening; smaller investments are not reviewable by FIRB.
- Conditions that duplicate existing legal requirements on businesses operating in Australia add to the regulatory burden without delivering additional benefits. For example, ‘standard tax conditions’ appear to be of limited value, as they mostly require companies to comply with Australian tax laws.

In general, national laws and regulations are a more responsive and proactive way to identify risks, and are likely to be a more effective way to manage risks. Moreover, they can target emerging risks and vulnerabilities wherever and however they arise in the economy, rather than assessing risks at a point in time associated with large foreign investments. Well-designed national regulations, together with adequately-resourced regulators — such as the Australian Taxation Office (ATO) or the Australian Competition and Consumer Commission (ACCC) — should generally be preferred. The increased prevalence of conditional approvals means that FIRB is operating alongside regulators with overlapping responsibilities and remedies.

Sometimes, conditions may be necessary to mitigate particular risks, but their necessity suggests that national laws and regulations need to be strengthened. Cases where conditions are needed are more likely to be the exception than the rule and in general, conditions that duplicate tax and regulatory requirements should be avoided. In other cases, conditions can play a role in maintaining public confidence that the national interest is being served.

The creation of the Critical Infrastructure Centre (CIC) in January 2017 (box 4.1) is a good example of developing national regulations to address ongoing risks, regardless of ownership. Activities conducted by the CIC include firm-level assessments of risks and weaknesses, offering advice to asset owners to mitigate risks, regulating the access to or operations of assets and monitoring the development of new industries or technologies for additional vulnerabilities.

In establishing the CIC, the Australian Government noted its intent was to complement the FIRB screening regime:

The FIRB process is one existing mechanism through which the Government can implement risk mitigations. However, this only applies to foreign investments above certain thresholds at the time of the proposed transaction. It is not possible to use it as a mechanism to address risks in outsourcing or offshoring for assets owned by domestic entities or where sales fall outside of the FIRB screening thresholds. As a result, outside of the FIRB process, the Government is not well placed to implement some of the required mitigations to address national security risks. (Dutton 2018, p. 5)

The Minister's 'directions' power in the *Security of Critical Infrastructure Act 2018* is more extensive than that under the foreign investment regime. It allows conditions to be imposed to mitigate risks as they emerge and evolve. It also appears to allow the Government to block a foreign purchase of any critical infrastructure asset or to force an existing owner to divest their ownership if it is 'reasonably necessary' to eliminate or reduce risks (under s. 32(3) of the Act). Nor is it subject to the same monetary screening thresholds as is the foreign investment regime (CIC 2018a; Dutton 2018).

The flexible nature of these powers may mean that less reliance need be placed on the foreign investment application process through FIRB, at least to the extent that national security risks relate to critical infrastructure.

The Australian Government's proposed national security test for sensitive assets and related measures increase the Treasurer's powers in this area (similar in some regards to the powers under the critical infrastructure security regime). It remains to be seen how this will operate, although since a new category of business will be brought under the Treasurer's power, more conditions are likely to be imposed.

Box 4.1 **Critical infrastructure and the CIC**

The Critical Infrastructure Centre (CIC) is responsible for promoting the security of critical infrastructure, in conjunction with owners and operators. It was established in the Attorney General's Department (before moving to the Department of Home Affairs) by the *Security of Critical Infrastructure Act 2018* (SOCI Act) and changes to the *Telecommunications Act 1997*. The SOCI Act has two key components:

- the establishment of a **'register' of critical infrastructure assets**. Owners or operators are required to report 'interest and control' and 'operational' information to the Government, in order to understand who owns, controls and has access to the highest-risk assets
 - Under s. 9 of the SOCI Act, any asset can be prescribed as a 'critical infrastructure asset' if the Minister is satisfied that the asset is critical to Australia's 'social or economic stability', 'the defence of Australia' or 'national security' and that 'there is a risk, in relation to the asset, that may be prejudicial to security'. Under s. 51, the Minister can also privately declare an asset to be critical infrastructure if 'there would be a risk to national security if it were publicly known that the asset is critical infrastructure'.
 - Thus far, only electricity, port, water and gas assets are legislated as critical infrastructure, although the CIC has also identified transport, health, food, government services, and banking and finance as other critical infrastructure sectors. The SOCI Act currently applies to 165 assets, although the list of assets is kept secret.
- a new **'directions' power for the Home Affairs Minister**, allowing the Minister to issue directions to asset owners and operators to manage an identified risk that is prejudicial to security if other mechanisms cannot be used.
 - Examples of a direction may include requiring data storage offshore to be moved to a more secure location or the implementation of additional cyber security measures.

The main aim of this new regime is to manage the risks associated with foreign involvement in Australia's critical infrastructure, through which malicious actors 'can have subtle effects on the continuity of services to citizens, as well as extreme consequences for other dependant infrastructure of defence assets' (Dutton 2018, p. 2).

The CIC also provides national security advice on foreign investment applications to FIRB and works with Treasury to manage compliance with foreign investment approval conditions.

Sources: CIC (2018a, 2018b), Dutton (2018), FIRB (2019, pp. 19–20).

Enforcing conditions: should FIRB be a regulator?

The growing use of conditional approvals means there is an ongoing need for compliance monitoring to ensure that the conditions have been met. This is changing and expanding Treasury and FIRB's role, from that of a gatekeeper to a regulator as well.

Currently, FIRB has an independent board with a secretariat located within the Treasury. This structure suits the role of gatekeeper better than that of regulator. Treasury is well-positioned to provide advice on economically and politically difficult approval decisions.

However, it is unusual for regulatory roles to be situated within departments of state. Modern regulatory practice separates policy advice from the ongoing implementation and administration of that policy, to avoid regulatory ‘capture’ by interest groups and to build expertise, skills, resources and incentives to become high-quality administrators or regulators (PC 2019, p. 475).

For these reasons, regulators are normally established as statutory bodies at arm’s length from the government of the day. For foreign investment, only some of Treasury and FIRB’s regulator-like roles have been relocated. In 2015, responsibility for compliance with tax conditions and restrictions on foreign acquisitions of real estate moved to the ATO. This saw the ATO expand monitoring and compliance, which the Australian National Audit Office concluded was, overall, beneficial:

When decisions are being taken about where to place a function, consideration should be given to the expertise and capability of potential delivery entities and which entity has the best fit of skills to administer the function. In the case of managing compliance with foreign investment in residential real estate, the function would have been best placed initially into the ATO rather than Treasury. (ANAO 2018, p. 12)

Until recently, the FIRB process has lacked the graduated enforcement toolkit available to other regulators. In June 2020, the Australian Government announced a range of new penalties, compliance and enforcement powers for Treasury and the ATO. These new powers will give Treasury and the ATO greater ability to respond proportionately to issues of non-compliance, further increasing their regulatory roles. It remains to be seen how these powers will be used in practice.

Given the regulatory roles of Treasury and FIRB have expanded significantly, consideration should be given to the most suitable institutional design to support both decision-making on foreign investment applications and, if conditions are imposed, subsequent monitoring and enforcement of compliance.

4.3 Improving certainty and transparency

Wholesale change to screening processes would require significant political investment. Yet, within the existing framework, three areas of regulatory practice could be improved. These relate to greater clarity on the reasons for decisions (enabling lawyers to better advise their clients), set time periods for decision making (reducing uncertainty for potential investors), and structuring application fees to align more closely with the costs of administering the regulatory regime.

Publishing reasons for decisions

Transparency of decision making is low. While some tactful discretion must be maintained around threat assessments (to terrorist attack, espionage or sabotage) and vulnerabilities must

not be telegraphed, the Australian Government's treatment of investment applications is unusually secretive. When a foreign investment proposal is blocked, the action of the Treasurer is gazetted, but no reasons are provided for the decision. The Treasurer only occasionally issues a press release stating the decision and the reasons for it (usually when an investment proposal has a high profile). And if the Government identifies potential problems with an application and encourages the investor to withdraw, there is no public communication at all. Indeed, the Treasurer has stated that this has occurred on a number of occasions.

Well, I actually have rejected a number of proposed acquisitions, some of which you know about and some of which you don't. And the reason why you don't is because the application comes in, I assess it and I say no and then they withdraw that application before it ever sees the light of day. (Frydenberg 2020b)

The lack of public disclosure is at odds with good regulatory practice.

Poor understanding of the decision-making process, particularly the reasons for applications being rejected, may mean Australia is seen as a difficult country in which to invest.

The FIRB process has often lacked transparency to foreign investors, sometimes appearing arbitrary and capricious in its operation and sending mixed signals. FIRB officials have struggled to communicate the government's foreign investment policy in clear and consistent ways, implying the policy was not well-defined, even within government. The information and data publicly supplied by FIRB has been inadequate in helping the government, parliament and the public understand the process and the nature of foreign investment in Australia. (Kirchner and Mondschein 2018, p. 12)

Similar views were expressed by the 2016 Senate Economic References Committee inquiry into the foreign investment review framework:

... the evidence provided during the inquiry suggests that the assessment process is seen by many stakeholders as predominantly ad hoc, with little indication of how important criteria, such as the national interest test, are interpreted by the Treasurer, FIRB and other government agencies. (SERC 2016, p. 52)

The Committee recommended that Treasury should 'publish the Treasurer's rationale behind both positive and negative decisions, in order to inform the public and to instil public and investor confidence in the review process' (SERC 2016, p. ix). This recommendation was not adopted.

One of the obstacles to greater transparency is the need to preserve confidentiality. Yet this does not seem insurmountable. The ACCC faces similar issues with its merger review processes and manages to be transparent while preserving confidentiality. Similarly, foreign investment screening processes in other countries seem able to strike a better compromise than we do.

- The President of the United States publicly announces decisions to block investment, and the Committee on Foreign Investment in the United States reports annually to Congress (confidentially) on its investigations (Congressional Research Service 2020, p. 10).

-
- The Canadian government publishes a list of completed decisions and notifications of foreign investments each month (Government of Canada 2020).
 - The New Zealand Overseas Investment Office publishes reasons for granting or declining applications (except for residential land applications) every month (Land Information New Zealand 2019).

Overall, foreign investment decision-making processes in Australia are more opaque than in other similar countries, and compared with other similar Australian administrative processes. Routine publication of reasons for decisions would improve investor certainty and lower the economic costs of the screening regime.

The timeliness of decision making

Long timeframes, particularly where they are uncertain, can act to discourage foreign investment. They add to legal costs and disrupt business preparations for a merger or investment. These costs can be significant, for example where global mergers are unable to proceed until approved within all host jurisdictions.

FIRB seeks to provide timely decisions. It has a statutory timeframe of 30 days in which to respond to investment applications. If a decision has not been made within the statutory timeframe (and the applicant has not been advised), the application is deemed to be approved. The Treasurer can also issue an Interim Order to extend the examination period for up to 90 days. Or alternatively, FIRB can suggest to the applicant that they agree a longer period and so avoid the need for an Interim Order. In March 2020, the Treasurer announced changes to the foreign investment framework (during the COVID-19 pandemic) that would temporarily increase processing timeframes from 30 days up to 6 months (chapter 2).

In practice, the median application processing time by the FIRB was 45 days in 2018-19. For the ATO, it was 23 days for non-sensitive commercial applications and nine days for residential applications (FIRB 2020b, p. 7).

Treasury and the ATO have some flexibility in their powers to quicken decision making. For example, senior Treasury and ATO staff can use delegated powers to decide on non-sensitive investment proposals that are consistent with the policy. This seems to be the case with a large majority of foreign investment applications by number, though not necessarily value. About 96 per cent of investment proposals, mostly real estate, were decided this way in 2013-14 (the last year such numbers were published; FIRB 2015, p. 6).

The time taken for decisions relating to sensitive or complex investment proposals is likely to take longer than the average. But this information is not publicly available, since the FIRB does not disclose how often decisions are reached within the statutory timeframe, how often the timeframe is extended, or how often applications are deemed to be approved due to the decision timeframe elapsing.

As with other regulatory processes, administration of Australia's foreign investment regime should achieve its policy goals while keeping the compliance burden to a minimum. The statutory timeframes provide some assurance to investors that decisions will be timely and predictable. Inevitably, however, there will be variations on the timeliness of some decisions, given the diversity of investment proposals screened and the need to take advice from multiple government agencies (not all of whom are resourced specifically for this function).

Nonetheless, there is scope to provide more certainty to investors. As a first step, FIRB should provide more detailed annual reporting on the timeliness of decisions to assist an understanding of the extent of the problem. The Commission has also heard from stakeholders that they need advance warning when standard timelines will not be met, to allow them to manage acquisitions or pursue alternatives efficiently.

The setting of application fees

At the time the Government introduced application fees, it stated that they were intended to recover the costs of administering the regulatory regime.

The imposition of fees helps fund the costs of considering applications, the introduction of a specialised investigative and enforcement area within the [ATO], improvements in the collection of data about foreign investment in Australia, and an increase in the resources dedicated to the investigation of alleged breaches of the Act. The introduction of fees is also consistent with the Australian Government's policy that the full cost of regulating a particular sector should generally be recovered from that sector. (Australian Government 2015, p. 89)

Cost recovery can promote efficiency and equity, but where a government charge is out of all proportion to the cost of providing the service, it is *a tax*, not a fee-for-service (ABS 2015, p. 75). Moreover, such fees for foreign commercial investment are an inefficient source of revenue — they encourage foreign investors to look for opportunities elsewhere and discourage the sale of existing operations to businesses with more ambition to grow and contribute to the Australian economy.

More generally, taxing foreign businesses reduces foreign investment, leading to lower Australian wages and incomes (chapter 3). While the fees on large commercial transactions are likely to be immaterial, the relatively much higher fees on small agricultural investment applications have the potential to detract from growth in regional communities (box 4.2).

The Australian Government collects far more fee revenue than it spends on the foreign investment review process. In 2017-18, the government collected \$114 million in fee revenue, while the operational costs of FIRB and its secretariats in the Treasury and the ATO totalled only \$14.7 million (FIRB 2019, pp. 11, 52).

In June 2020, the Australian Government announced that it would be reviewing the foreign investment fees framework to reflect the enlarged roles and responsibilities of foreign investment activities across government, including aspects related to national security. The Government announced that it would be providing about \$50 million over four years to

agencies to support the increased roles and responsibilities. If fees collected in future years are anything like those collected in 2017-18, then there would still be ample funding already available under the existing fee framework.

In the Regulation of Agriculture inquiry, the Commission recommended that the Australian Government should set application fees for foreign investment proposals at a level that recovers the screening costs incurred by FIRB, and closely monitor the fees so that there is no over- or under-recovery of costs (PC 2016b, p. 566). The case for reform has not changed since that inquiry, and if anything, it has strengthened.

Box 4.2 Is farming different?

Australia's agricultural sector needs additional investment to expand production and reap the full benefits of a rapidly growing demand for high value products from the burgeoning Asian middle class (PC 2016b, p. 537; Uren 2015, p. 153). Yet selling the farm evokes patriotic sentiment, especially in those communities where foreign companies seek to purchase agricultural assets.

The public opposition to foreign investment in agriculture is reflected in the recent tightening of foreign investment policies. In 2015, for example, the Government lowered the screening thresholds for agriculture from \$252 million to \$15 million (and to \$55 million for agribusiness) and created the register of foreign owned agricultural land, increasing reporting requirements for foreign investors (chapter 2). Application fees also rose much more rapidly for investments in agricultural land and agribusiness than for general business investment applications.

High barriers to foreign investment in agriculture increase investor costs and are likely to reduce economic activity, jobs and growth prospects in regional communities. It was for this reason that, in 2016, the Commission recommended that the Government should align fees with administrative costs and increase the screening thresholds on agricultural land and agribusiness to match those in other sectors (PC 2016b, p. 555).

4.4 Summing up

The Australian Government's foreign investment policy aims to 'balance the need to welcome foreign investment against the need to reassure the community that the national interest is being protected' (Australian Government 2019, p. 9). And as the Lowy Institute observed 'no government, no matter how supportive of foreign investment, is going to give up its discretion to review potentially sensitive foreign investment proposals' (Thirlwell and Shearer 2008, p. 9). But as with all areas of public policy that give rise to material costs, it is appropriate to ask whether it can be improved.

This chapter identified some aspects of the current policy regime that work well, and others that could be improved. On the positive side, the design of the national interest test and vesting decision-making responsibility with the Treasurer is working well. It ensures a weighing of the economic benefits against risks, and the 'negative test' means the great majority of investment applications are approved. The position of the FIRB secretariat within Treasury suits its role in providing economic advice to the Treasurer on investment decisions.

Yet there are also unnecessary costs associated with the processes used to administer foreign investment policy. Against the benchmark of leading regulatory practice, these costs are material and higher than they need to be (chapter 2). This chapter has identified scope to improve the administration of Australia's foreign investment policy, specifically relating to:

- providing tighter policy guidance around issues to be considered in assessing the national interest, and narrowing it down to exclude those criteria where the risks can be adequately mitigated through national regulations (such as competition)
- improving guidance to investors and their advisors about the evolving interpretation of the national interest, through the publication of decisions (not necessarily at the time they are taken)
- giving certainty and improved transparency about timelines, through early advice to investors when standard time frames will not be met and the publication of more detailed annual statistics
- improving policy coherence with national regulators, by avoiding imposing conditions that duplicate regulatory requirements
- assuring that application fees are set to recover administration costs, without over- or under-charging.

A Modelling methodology

The modelling undertaken attempts to quantify the economic effects of foreign direct investment (FDI) policies. It is designed to illustrate that Australia's FDI policies have a material cost that should be taken into account when assessing the merits of a change in FDI policy. This appendix outlines the approach of the modelling exercise conducted and presented in chapter 3. It outlines the scenario modelled (section A.1), the methodology (section A.2) and a sensitivity analysis (section A.3).

The modelling approach involves two steps. The first step relies on Organisation for Economic Cooperation and Development (OECD) work that attempts to estimate the effect of regulation on foreign investment, whether by blocking or discouraging investment proposals. This analysis estimates the elasticity of inward FDI stocks to changes in the restrictiveness of FDI policy regimes using a cross-country panel of foreign investment data (Mistura and Roulet 2019). In the second step, these estimates are entered into the Commission's computable general equilibrium (CGE) model (PC Global).

To summarise the results, Australia runs an FDI regime that is more restrictive than in most other advanced economies. To the extent foreign investment proposals are blocked or discouraged by the regime, this results in lower Australian household incomes than if the regime were more narrowly focussed. These economic costs are material — in the order of \$0.8 to \$7.1 billion per year — though not large in the context of Australia's nearly \$2 trillion economy.

A.1 Scenarios modelled

The modelling exercise considers a scenario where a hypothetical change in Australia's regulatory policy on FDI leads to a change in foreign-owned capital located in Australia.

Using the OECD's FDI restrictiveness index (outlined below and in chapter 2), the scenario involves an increase of 60 per cent in Australia's index score, which would bring it roughly in line with New Zealand, the highest scored OECD member country. The methodology, including the construction of the shocks and the model used, are outlined in the next sections.

A.2 Methodology

The quality of the modelling results depends upon the accuracy of the OECD's analysis in constructing the index of FDI restrictiveness, the cross-country panel analysis of the

statistical relationship between restrictiveness and investment, and the reliability of the PC Global CGE model in mapping these changes through to economic effects.

OECD estimates of the FDI to restrictiveness elasticity

The OECD's FDI restrictiveness index gives an indication of the level of regulatory restrictions. The index reports an annual measure of FDI restrictiveness based on an assessment of regulations in place within every OECD country and select non-member countries (Kalinova, Palerm and Thomsen 2010). The measures are weighted by industry, as industry composition differs between countries, to make more reasonable comparisons across countries. The index reports on four types of measures: equity restrictions; screening and approval requirements; restrictions on foreign key personnel; and other operational restrictions (table A.1).

The OECD's index scores between zero (no regulatory restrictions on FDI) and one (highly restrictive regulations blocking FDI). These are applied to 22 sectors and the four types of restrictiveness types, which are averaged to obtain the aggregate country score (figure A.1). The OECD attempts to gauge scores according to the scope of the measure. For example, if a country has a measure that is not applied to a large amount of regional economic partners, then the score is reduced. Likewise, if a restriction does not apply to greenfield investments, or only affects part of a sector, the scores are reduced accordingly.

While the OECD measure of FDI restrictiveness is the best available, it has some serious limitations. In particular, it measures statutory restrictions and not how the measures are enforced. For example, while it assesses the range of investments subject to screening, it generally does not distinguish between positive and negative tests, nor the criteria used to assess whether investments can proceed. It also excludes screening that is strictly for national security purposes.

Table A.1 How the OECD scores the restrictiveness of FDI policy

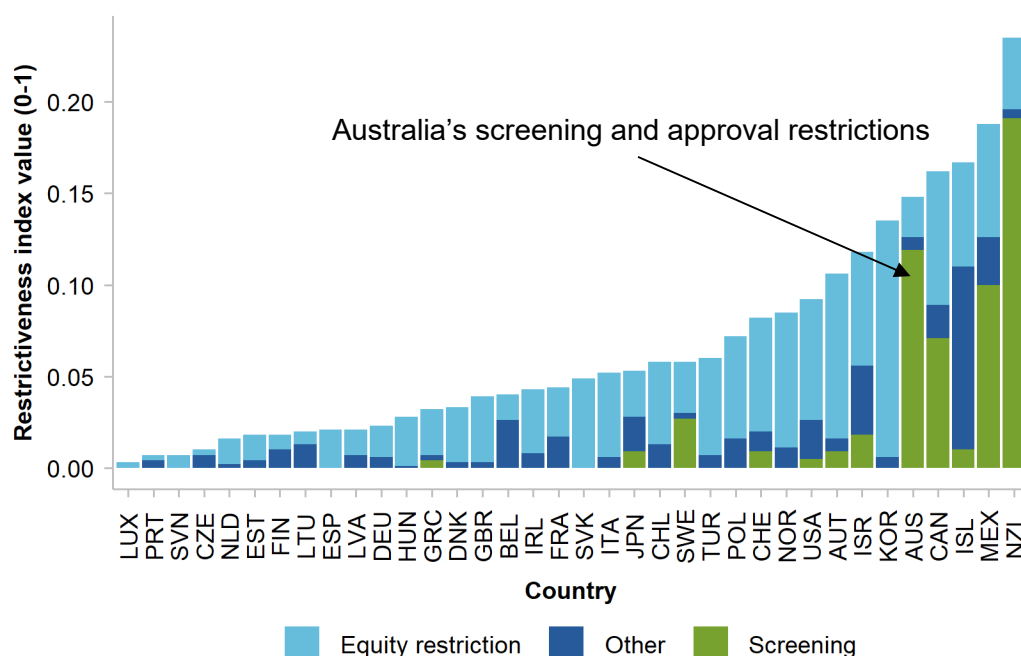
'Equity limits', 'screening', 'personnel restrictions' and 'other restrictions' are the four main areas

Categories		Scores
Foreign equity limits		
<i>Start-ups and acquisitions</i>	No foreign equity allowed	1
	Foreign equity < 50% of total equity	0.5
	Foreign equity > 50% but < 100% of total equity	0.25
<i>Acquisitions only</i>	No foreign equity allowed	0.5
	Foreign equity < 50% of total equity	0.25
	Foreign equity > 50% but < 100% of total equity	0.125
Screening and approval^a		
	Approval required for new FDI/acquisitions of < US\$100m or if corresponding to < 50% of total equity	0.2
	Approval required for new FDI/acquisitions above US\$100m or if corresponding to > 50% of total equity	0.1
	Notification with discretionary element	0.025
Restrictions on key foreign personnel/directors		
	Foreign key personnel not permitted	0.1
	Economic needs test for employment of foreign key personnel ^b	0.05
	Time bound limit on employment of foreign key personnel ^b	0.025
	Nationality/residence requirements for board of directors: majority must be nationals	0.075
	Nationality/residence requirements for board of directors: at least one must be national	0.02
Other restrictions		
	Establishment of branches not allowed/local incorporation required	0.05
	Reciprocity requirement	0.1
	Restrictions on profit/capital repatriation	1 – 0.01
	Access to local finance	0.05
	Acquisition of land for business purposes ^c	0.1
	Land ownership not permitted but leases possible	0.05 – 0.01
Total		Up to 1

^a Excludes screening based solely on national security grounds. ^b If both restrictions apply, 0.05 is added to score. ^c Score scaled by 1/3 when the measure applies only to border and coastal areas and by a factor of 5 for agriculture and forestry.

Source: Kalinova, Palerm and Thomsen (2010, p. 11).

Figure A.1 The OECD index of FDI restrictiveness



^a The restrictiveness index goes from 0 (no restrictions), to 1 (completely closed to FDI).

Source: OECD (2019b).

Despite these limitations, the OECD restrictiveness index is correlated with inward FDI stocks across advanced economies. Econometric analysis shows that, even after controlling for other factors that may affect FDI stocks, there is a significant negative relationship between restrictiveness and FDI stocks. The elasticities used to construct the model shocks use results from an OECD paper by Mistura and Roulet (2019) that quantified these effects using various controls (box A.1). The specific elasticity results from their gravity regression are reported in table A.2. The aggregate elasticity used for the main result can be interpreted as: a 10 per cent increase in the restrictiveness index results in a 2.1 per cent reduction in inward FDI stocks. The screening elasticity is used only for sensitivity analysis (section A.3).

The restrictiveness index and the econometric estimates of elasticities form the basis for the analysis. These measures are then used as a foundation for a reasonable construction of the effects that policy changes could have on the stocks of FDI located in Australia.

Box A.1 **Estimating the elasticity of FDI to restrictiveness**

Mistura and Roulet (2019) consider 60 advanced and emerging economies over the period between 1997 and 2016 to estimate the elasticity of bilateral FDI positions to FDI restrictions measured by the index. They estimate that a 10 per cent increase in aggregate restrictiveness results in about a 2.1 per cent decrease in FDI stocks, or about a 1.1 per cent decrease when only increasing screening and monitoring restrictions (table A.2).²⁸

The difference between these estimates is because equity ownership restrictions, while isolated to particular investments, tend to constrain investment more than screening processes. The main modelling exercise (presented in chapter 3) uses the aggregate elasticity to estimate the effect that a change in foreign investment policy has on the Australian economy. The sensitivity analysis uses the screening elasticity, as screening is Australia's main policy tool.

Mistura and Roulet use a Poisson pseudo-maximum likelihood gravity regression technique, the typical and preferred method for this type of cross-country analysis for international trade problems. They use inward FDI stocks as the dependant variable and a range of 20 controls, such as the size of economies, quality of institutions, common language and free trade agreements. They also run an alternative regression using mergers and acquisitions data as the dependent variable that shows similar qualitative results with some different quantitative results.

Sources: Mistura and Roulet (2019) and Kalinova, Palerm and Thomsen (2010).

Table A.2 Mistura and Roulet's (2019) econometric results^a

<i>Explanatory variable</i>	<i>FDI inwards</i>
FDI restrictiveness (aggregate)	-0.208*** (-2.82)
FDI restrictiveness (equity)	-0.287*** (-3.84)
FDI restrictiveness (screening)	-0.107*** (-3.43)
FDI restrictiveness (other)	-0.008 (-0.18)
+ 20 controls, and country and year fixed effects.	

^a *, **, *** indicate statistical significance at the 10%, 5% and 1% levels. Z-scores are in parenthesis. Results can be interpreted as simple elasticities. Results do not include the large set of controls used in this analysis.

Source: Mistura and Roulet (2019).

²⁸ The elasticity of foreign investment to screening restrictiveness (of -0.107) is consistent with the semi-elasticity of -0.7 estimated by Nicoletti, Golub and Hajkova (2003) when considering small changes in restrictiveness and for Australia.

Creating the scenario shocks

The scenario shocks are created by changing capital income taxes on foreign investment²⁹ in a manner calibrated to achieve a change in the quantity of inward FDI implied by the OECD modelling.³⁰ That is, the ad valorem equivalent tax on *foreign* capital income of a change in restrictiveness is calculated. It is tax on capital income that is equivalent to the change in FDI located in Australia due to a change in restrictiveness.³¹ It is a similar approach to implementing a tax equivalent quota on FDI, but instead a tax on capital income is used as a proxy as it was already contained in the model and was adequate for the small illustrative modelling task required. The final figures are presented in table A.3, which includes other scenarios modelled in the sensitivity analysis (section A.3).³² These shocks are entered into the PC Global CGE model.

Table A.3 Shocks and scenarios

Inputs to the PC Global CGE model from changes in restrictiveness

Country	Elasticity	Estimate	FDI quantity shock	Ad valorem equivalent
Higher restrictiveness (NZ)	Aggregate ^a	Lower	-0.59%	6.63%
		Central	-2.58%	29.20%
		Higher	-5.66%	63.96%
	Screening	Lower	-0.51%	5.77%
		Central	-1.36%	15.37%
		Higher	-2.39%	27.01%
Lower restrictiveness (US)	Aggregate	Lower	0.64%	-7.22%
		Central	3.01%	-34.07%
		Higher	7.07%	-79.97%
	Screening	Lower	0.55%	-6.24%
		Central	1.51%	-17.10%
		Higher	2.74%	-30.95%

^a Main scenario, as reported in chapter 3.

Source: Commission estimates.

The mechanisms that lead from a change in restrictiveness to a change in capital stocks are outlined in figure A.2. In simple terms, higher restrictiveness increases the cost of capital to foreign investors, causing some investors to be unwilling to make investments, and the quantity of FDI decreases. One consequence is that Australian businesses are somewhat less

²⁹ ‘Investment’ refers to stocks, rather than flows, which are not linked to the model shocks, but simply refer to the changes in stocks of investment located in different countries rather than changes in annual flows.

³⁰ In the model, revenue collected through this mechanism is rebated to foreigners as a lump sum and does not flow through to estimated changes in Australian gross national income (GNI).

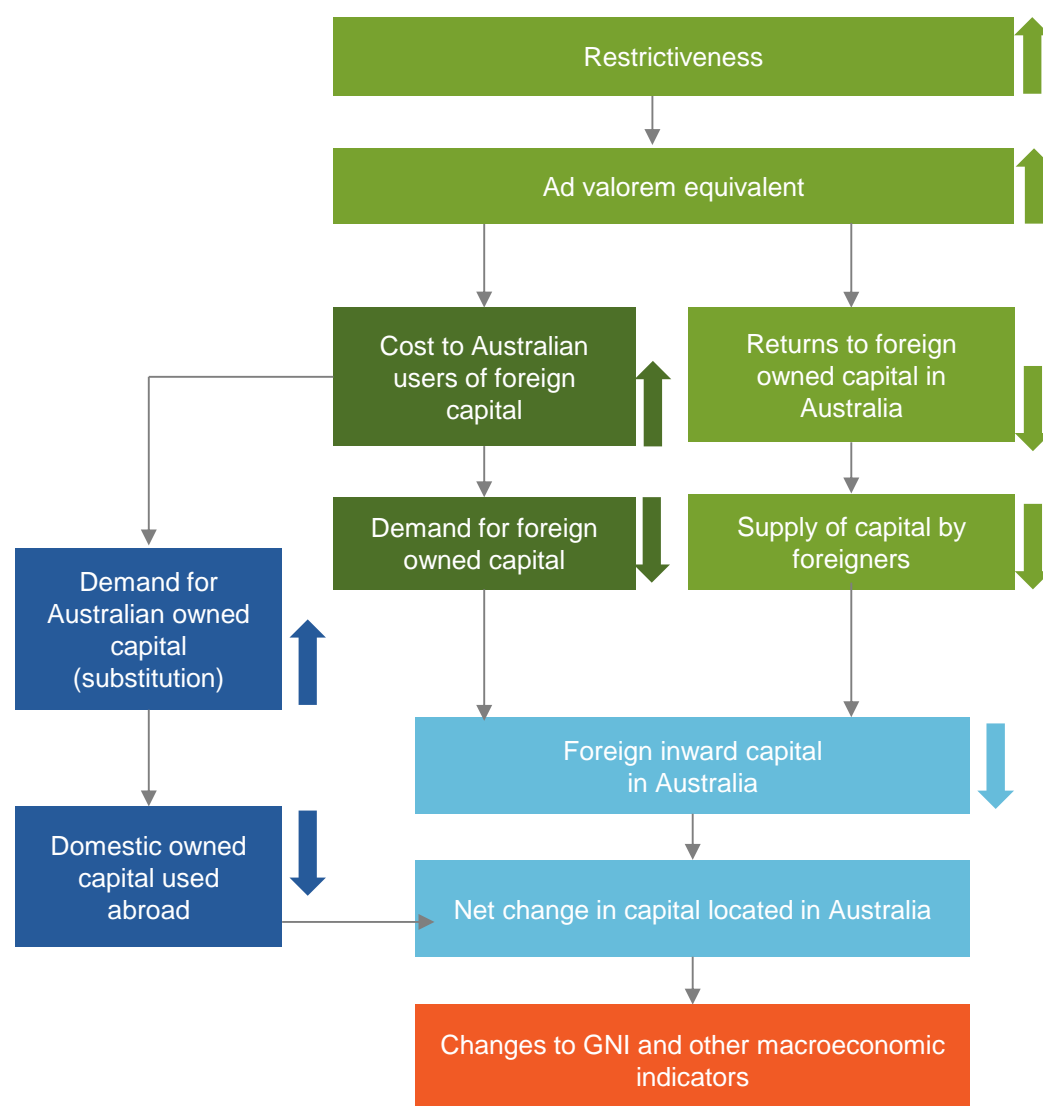
³¹ The design of the shocks takes account of the share of FDI in total inward investment.

³² Further details of the PC Global CGE model can be found in the technical appendix of the Commission’s paper on *Rising Protectionism: Challenges, threats and opportunities for Australia* (PC 2017a).

likely to be foreign owned, which leads to less Australian income being available for either consumption or investment overseas. Overall Australia ends up with a lower total capital stock than when under lower restrictions.

Figure A.2 The mechanisms at play

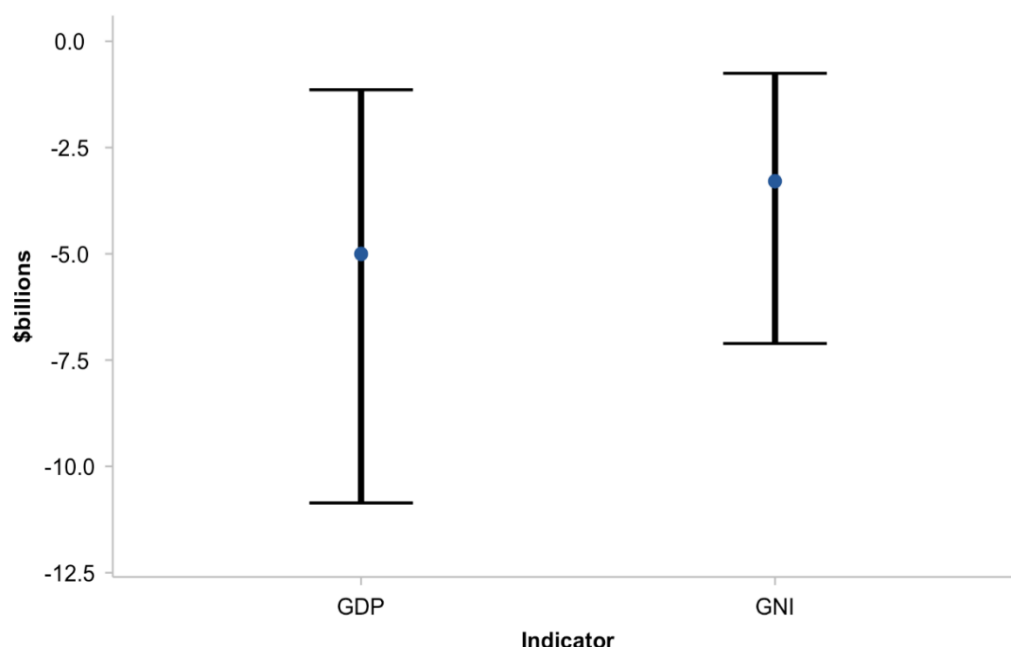
How to go from a change in policy, to a change in gross national income (GNI)



Main results and additional reporting

The main scenario results (figure A.3), as well as additional results from the main model such as changes in capital stocks, wages and return to capital (table A.4) are reported below.

Figure A.3 Restricting FDI hurts the Australian economy
 Simulations of the effect on the Australian economy of adopting a more restrictive FDI regime, similar to the level of New Zealand^b



^a Percentage changes from the model are applied to current Australian gross domestic product and gross national income levels. ^b Error bars show high and low sensitivity tests based on estimates of the elasticity of foreign investment to FDI restrictiveness that are two standard deviations above and below the central estimate.
 Source: Commission estimates.

The additional results reported in table A.4 are shown in percentage point changes from the baseline, the most notable being the net change in investment stocks in Australia. This shows that the higher restrictiveness leads to less foreign investment in Australia, which is largely replaced by domestic capital repatriated from abroad (although not entirely, because while there is some assumed substitutability of capital, it is not entirely substitutable). Therefore, Australia is left with less total investment than would otherwise be the case were Australia's FDI restrictiveness policies not increased.

Table A.4 Detailed PC Global CGE results from main scenario

Percentage change of variables from baseline

<i>Indicator</i>	<i>Lower</i>	<i>Central</i>	<i>Higher</i>
GDP	-0.06	-0.26	-0.56
GNI	-0.04	-0.17	-0.38
Rate of return (capital)	0.06	0.25	0.55
Wages ^a	-0.05	-0.24	-0.52
Inward foreign investment	-0.59	-2.58	-5.58
Outward foreign investment	-0.29	-1.25	-2.71
Net investment ^b	-0.31	-1.33	-2.87

^a As is standard in CGE models, unemployment is fixed while wages are allowed to adjust. This means that the change in wages is very likely to contain some changes in unemployment. ^b Net investment is inward investment less outward investment resulting in the total change in investment stocks in Australia

Source: Commission estimates.

A.3 Sensitivity analyses

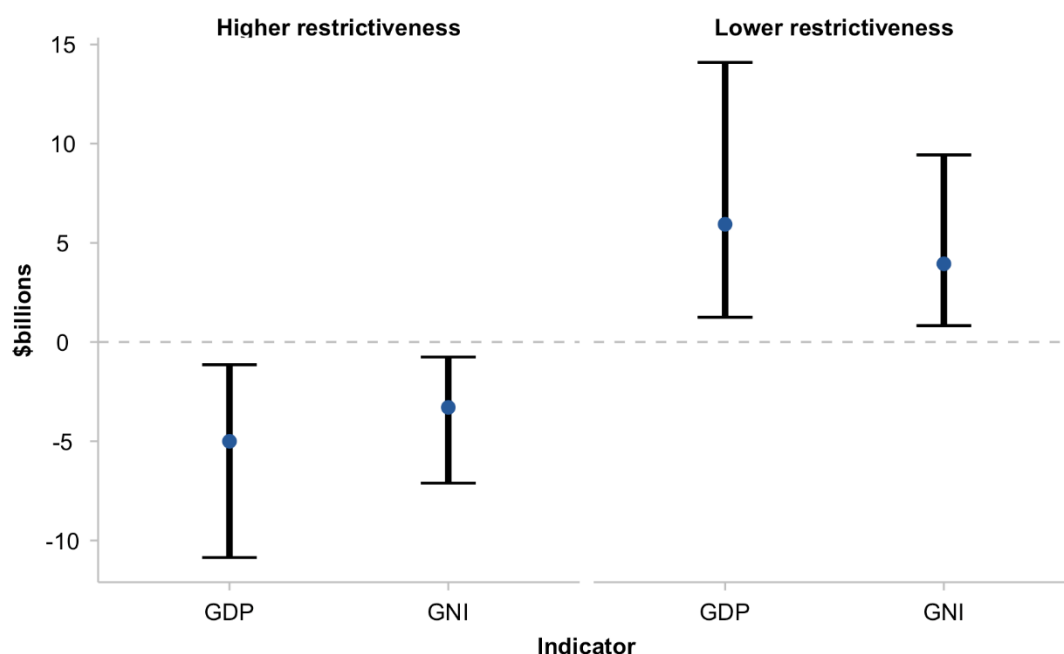
Due to the considerable uncertainties inherent in attempting to model the scenarios, three sensitivity analyses were undertaken:

1. using higher and lower bounds of the elasticity estimates as inputs (included in the main results)
2. using the screening elasticity rather than the aggregate elasticity estimated by the OECD (discussed below)
3. estimating a *reduction* in the restrictiveness index score of 40 per cent, making Australia's restrictiveness similar to the level of the United States (discussed below).

A sensitivity analysis is conducted based on uncertainty in the OECD estimates of the elasticity of the foreign investment stock to changes in policy restrictiveness (figure A.4). The higher and lower scenarios reflect estimates that, in the context of the econometric model, are two standard deviations either side of the central elasticity estimates. In practice, uncertainty in parameters in the CGE model will also contribute to the range of results.

Figure A.4 **Aggregate elasticity results^a**

The higher restrictiveness results duplicate the main results in chapter 3

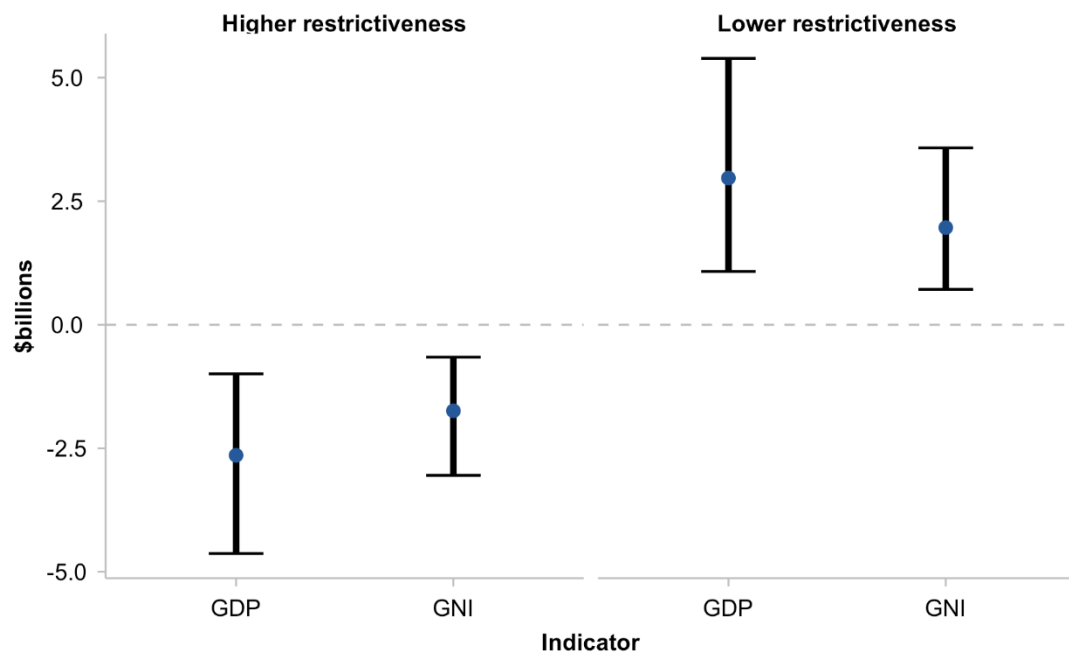


^a Percentage changes from the model are applied to current Australian gross domestic product and gross national income levels. Error bars show high and low sensitivity tests based on estimates of the elasticity of foreign investment to FDI restrictiveness that are two standard deviations above and below the central estimate.

Source: Commission estimates.

Similar to the above results, upper and lower bounds of the restrictiveness elasticity are applied to the screening elasticity. This elasticity is lower than the aggregate elasticity, which implies that inward FDI is less sensitive to screening restrictions than other measures of the index (figure A.5). The results show a smaller quantitative effect and less variation in estimates. These results are consistent with the qualitative results from the main scenario that FDI restrictions have non-zero effect on the Australian economy.

Figure A.5 **An alternative input: screening elasticity results^a**



^a Percentage changes from the model are applied to current Australian gross domestic product and gross national income levels. Error bars show high and low sensitivity tests based on estimates of the elasticity of foreign investment to FDI restrictiveness that are two standard deviations above and below the central estimate.

Source: Commission estimates.

B Would the ultimate beneficial owner please stand up? A China-Australia case study

Official data on Australia's international foreign direct investment (FDI) position are compiled by the Australian Bureau of Statistics (ABS) in line with statistical standards set out in the International Monetary Fund's (IMF's) *Balance of Payments and International Investment Position Manual, Sixth Edition (BPM6)* (ABS 1998; IMF 2009). They provide a reliable measure of Australia's aggregate investment. They also align closely with the estimates of foreign investment flows over the past decade from China's National Bureau of Statistics (NBS), albeit with slight variations from year to year (table B.1).³³

However, the source country for investment into Australia is based on the 'immediate owner' rather than 'ultimate beneficiary' in these official statistics. This provides a limited understanding of the origin of investment flows in circumstances where funds are routed through special purpose entities (holding companies) in countries such as Luxemburg or the Cayman Islands (and other jurisdictions with low tax rates). Researchers at the IMF described these funds as 'phantom FDI', passing through 'empty corporate shells':

These shells, also called special purpose entities, have no real business activities. Rather, they carry out holding activities, conduct intrafirm financing, or manage intangible assets — often to minimize multinationals' global tax bill. Such financial and tax engineering blurs traditional FDI statistics and makes it difficult to understand genuine economic integration. (Damgaard, Elkjaer and Johannesen 2019, p. 12)³⁴

Overall, this 'phantom FDI' was about 40 per cent of global FDI in 2017, a share which has been increasing in recent years (Damgaard, Elkjaer and Johannesen 2019, p. 12).

³³ Changes in Chinese capital control laws may contribute to these differences. In the decade prior to 2014, the Chinese Government had been embarking on a slow liberalisation of capital controls, but a policy reversal in 2014 saw implementation of new capital controls and stricter enforcement of the current rules. This is one potential explanation for the spike in 2014 inflows from China in the ABS data — prior periods were possibly influenced by Chinese investors trying to subvert capital control laws, leading to higher ABS figures (Liu 2018).

³⁴ Sources of phantom FDI are negatively correlated with corporate tax rates. Luxemburg, the Cayman Islands, the British Virgin Islands, Bermuda, Switzerland, Ireland, Mauritius, the Netherlands and Hong Kong are low-tax jurisdictions that make up the source of over 85 per cent of all phantom FDI (Damgaard, Elkjaer and Johannesen 2019, p. 12). On the other hand, phantom FDI is not necessarily nefarious in nature. There are legitimate reasons why a holding company may be appropriate, such as for financing arrangements or waiting for contracts to mature, but trying to disentangle these activities leaves a murky picture for policy makers.

B.1 Alternative data on investment flows

A number of organisations have developed alternative databases that identify the ultimate beneficial owner based on a company's public statements about intended or concluded investment. Each has their strengths and limitations. Three such examples on Chinese investment in Australia are the datasets compiled by:

- the American Enterprise Institute (AEI) and Heritage Foundation (HF)
- the University of Sydney (USyd) and KPMG
- the Australian National University (ANU).

Methodological approaches vary and in some cases are opaque. For example, the datasets are constructed using different criteria, such as minimum thresholds for inclusion, as well as different types of measurements, such as realised investment versus the contracted amount. In particular, the ANU's Chinese Investment in Australia (CHIA) dataset captures investment at the date of realisation while the AEI/HF and the USyd/KPMG datasets measure it at the date of contracting.³⁵

While annual estimates vary (table B.1), overall each of these datasets suggest that the flow of FDI into Australia for which Chinese investors are the ultimate beneficiary could be about three to four times larger than investment flows for which Chinese investors are the immediate owner (figure B.1). The differences are likely due to the ABS measuring net inflows, while the alternatives measure gross inflows; that a large part of Chinese investment flows through Hong Kong, Singapore or other financial hubs; and differences in methodology.

Another source of data that reports the ultimate beneficial owner are the Foreign Investment Review Board (FIRB) screening applications. The FIRB applications data transitioned from using an FDI origin approach, to using a 'look-through' approach for foreign investment ownership (where the ultimate beneficiary, rather than the immediate source of the FDI is identified) from 2017-18 (FIRB 2019, p. 64).

However, the FIRB data are not closely comparable with the other data series.

- FIRB data relate to applications for approval of intended investment. Investments might take several years after approval to be realised, or may not occur at all.
- FIRB applications are needed only where the value of the investment is above minimum value thresholds and only where there is change in voting power (e.g. establishment of a new business or direct equity injections into a wholly-owned subsidiary do not require applications).
- Some investors may structure their affairs to avoid FIRB's jurisdiction.

³⁵ One advantage of the CHIA dataset is its transaction-level data. These show, for example, that aggregate Chinese investment flows are strongly influenced by a small number of large transactions. For instance, in 2018 there were 10 transactions over \$100 million, with these large investments accounting for 87 per cent of total investment over the five years of available data (ANU 2018).

Overall, FIRB's data is likely to overestimate the real value of investment above the screening thresholds, while underestimating the value of investment below the thresholds.

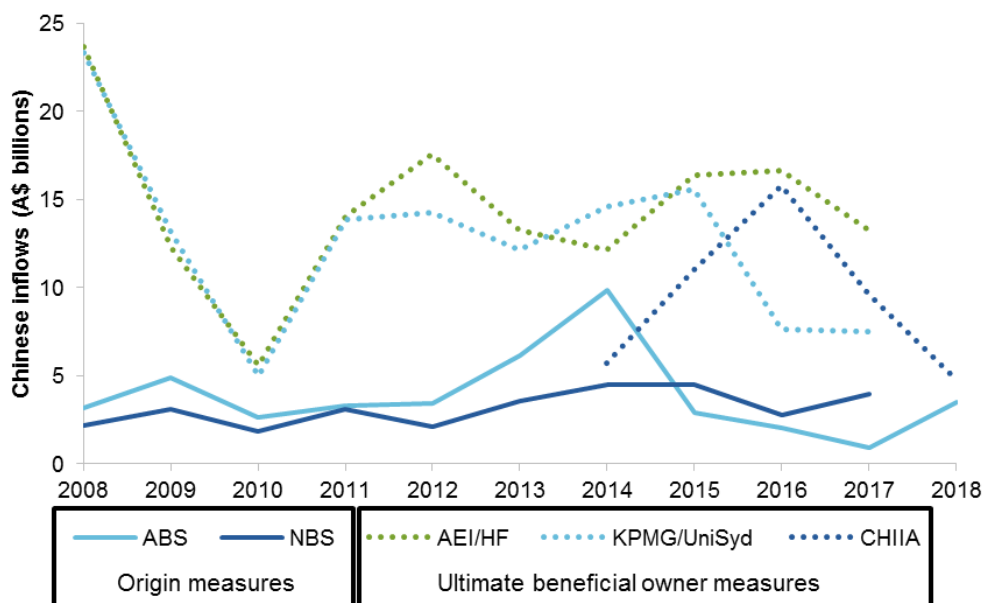
Table B.1 Comparing inflows of Chinese FDI into Australia
A\$ billions^a

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
ABS	3.19	4.86	2.63	3.27	3.44	6.15	9.86	2.90	2.03	0.91	3.51
NBS	4.72	4.87	3.43	2.91	3.17	3.30	2.55	3.91	3.38	3.44	
KPMG/UniSyd	23.67	12.25	5.56	14.05	17.56	13.30	12.13	16.36	16.67	13.3	8.2
AEI/HF	23.34	13.16	5.02	13.89	14.23	12.13	14.57	15.61	7.63	7.5	
CHIA							5.7	11.0	15.8	9.6	4.8
FIRB	7.5	26.6	16.3	15.0	16.2	15.8	27.7	46.6	47.3	38.9	23.7

^a National statistics do not measure ultimate beneficial ownership, which the other four sources do, using varying methodologies, although only in the latest year for FIRB data.

Sources: ABS, *International Investment Position, Australia: Supplementary Statistics, 2018*, cat. no. 5352.0 (table 2); AEI/HE (2019); ANU (2018); FIRB annual reports (various years); NBS (2018); and USyd/KPMG (2019).

Figure B.1 'Ultimate beneficial owner' measures are substantially higher than official 'immediate owner' statistics



Sources: ABS, *International Investment Position, Australia: Supplementary Statistics, 2018*, cat. no. 5352.0 (table 2); AEI/HE (2019); ANU (2018); NBS (2018); and USyd/KPMG (2019).

C A history of policy changes

By some accounts, Australia's foreign investment policy arose from concerns in the early 1970s over a foreign company attempting to take over the Australian company that manufactured the Chiko Roll (Uren 2015, p. 86). Since then, Australia's foreign investment policies and screening processes have undergone a wide variety of changes. Over the past 20 years, foreign investment policy has become *more* restrictive in some ways, with added restrictions on applications to invest in agriculture and agribusinesses (table C.1) and residential real estate (table C.2), as well as new requirements to guard against national security risks (table C.3). However, Australia's policy has also become *less* restrictive in other ways, particularly as general screening thresholds have risen substantially (table C.4).

Table C.1 Agriculture and agribusiness policy changes and announcements

<i>Date</i>	<i>Effect</i>	<i>Restrictiveness</i>
Jan 2012	Policy statement on agriculture investment released for transparency, to provide guidance on factors normally considered	
Aug 2012	Approved acquisition of Cubbie Group Ltd by a Chinese, Japanese and Australian consortium, conditional on partial divestment and restrictions on management and water use	
Nov 2013	Rejected proposed acquisition of Graincorp by US company Archer Daniels Midland	
Mar 2015	Agricultural land screening threshold lowered from \$252 million to \$15 million for non-FTA partner countries	
Jul 2015	Register of foreign ownership of agricultural land introduced, data collection commences	
Dec 2015	Agribusiness screening threshold reduced to \$55 million	
Apr 2016	Revised bid by Dakang Australia for S. Kidman and Co. (without Anna Creek station; table C.3) rejected due to concerns about size of remaining land holdings. Eventually sold to joint Australian-Chinese entity in Oct 2016	
Jul 2017	Register of foreign owned water entitlements introduced, increasing data collection requirements	
Feb 2018	Rules require foreign acquirers of agricultural land to demonstrate assets were publicly available to Australian bidders	

Table C.2 Residential real estate policy changes



















<i>Date</i>	<i>Gov't</i>	<i>Effect</i>	<i>Restrictiveness</i>
Sep 1999	Cwealth	Removal of limit of 50% foreign sales on off-the-plan 'house and land' packages. Exemption from approval requirements for special category visa holders, foreign spouses	
Jul 2005	QLD	Higher schedule of land tax introduced for absentee owners (including non-resident foreigners); additional surcharge (of 2%) added July 2019	
Dec 2008	Cwealth	Doubling of timeframe to develop vacant residential land (to 24 months); removal of \$300,000 limit for student visa holders; removal of 50% cap on foreign sales of off-the-plan developments; expansion of definitions of 'temporary resident' and 'new dwelling'; companies permitted to purchase established dwellings for Australian-based staff	
Mar 2009	Cwealth	Temporary residents no longer required to notify of acquisition of homes (except if for investment purposes or of multiple vacant blocks). Accommodation facilities treated as commercial real estate	
Apr 2010	Cwealth	Temporary residents required to notify and seek approval for all purchases of residential real estate, and to sell established housing if departing Australia. Foreign non-residents prevented from buying real estate if it does not add to the housing stock and required to build on vacant land within 24 months	
May 2015	Cwealth	Increased enforcement of residential real estate rules through moving compliance functions to the ATO	
Jul 2015	VIC	Stamp duty surcharge (of 3%) introduced for foreign purchases; raised to 7% from July 2016 and 8% from July 2019	
Jun 2016	NSW	Stamp duty surcharge (of 4%) introduced for foreign purchases; raised to 8% from July 2017	
Jan 2016	VIC	Land tax surcharge for 'absentee owners' (non-resident foreigners) introduced, with rate increases in 2017 and 2020	
Oct 2016	QLD	Stamp duty surcharge (of 3%) introduced for foreign purchases; raised to 7% from July 2018	
Jan 2017	NSW	Land tax surcharge introduced for foreign persons, with exemption for place of residence and rate increase in 2018	
May 2017	Cwealth	Annual vacancy charge introduced, payable if home is not occupied or available to rent for at least six months a year; 50% cap on pre-approvals of foreign ownership in new developments introduced	
Jul 2017	Cwealth	Reduced requirements for investors to seek multiple approvals for similar low risk transactions in residential real estate	
Jan 2018	SA	Stamp duty surcharge (of 7%) introduced for foreign purchases	
Jul 2018	ACT	Land tax surcharge introduced for foreign owners	
	TAS	Stamp duty surcharge (of 3%) introduced for foreign purchases	
Jan 2019	WA	Stamp duty surcharge (of 7%) introduced for foreign purchases	
Forth-coming	Cwealth	Register of foreign ownership of residential land to be released, based on state and territory data	

Table C.3 Foreign investment and national security policy changes and announcements

<i>Date</i>	<i>Effect</i>	<i>Restrictiveness</i>
Feb 2008	Principles of screening regime for foreign government investors (and agencies) released, for transparency	
Mar/Apr 2009	Proposed acquisition of OZ Minerals by China Minmetals blocked, due to mine proximity to a defence facility. Deal eventually proceeded, after the relevant mine was excluded	
May 2010	Announced any foreign mining investment requires Department of Defence assessment prior to FIRB screening	
Mar 2013	Revised definition of 'foreign government investor' introduced	
Nov 2015	NT Government sells 99-year lease on Port of Darwin to Landbridge (of China), despite proximity to defence facilities Sale of Transgrid lease by NSW Government approved with conditions guaranteeing Australia's involvement in management Bids for S. Kidman and Co. pre-emptively blocked due to cattle station proximity to defence facilities; revised bids without station proceed (table C.1)	
Aug 2016	Purchase of 99-year lease on Ausgrid by State Grid Corporation (of China) and CK Infrastructure (of Hong Kong) rejected, allegedly due to critical infrastructure for Pine Gap defence facility	
Jan 2017	Critical Infrastructure Centre established to manage national security risks to critical infrastructure	
Apr 2018	<i>Security of Critical Infrastructure Act 2018</i> established a confidential register of critical infrastructure (covering Australian and foreign owned assets), including information on the operation, ownership and control of the asset. Provides 'last resort' Ministerial power to direct the operator of an asset	
Feb 2018	Announced that all future sales of electricity assets would attract ownership restrictions or conditions for foreign buyers	
Aug 2018	Huawei and ZTE prohibited from involvement in rollout of 5G mobile network, due to concerns about extrajudicial directions from foreign governments creating risks of unauthorised access or interference in the network	
Mar 2020	The screening threshold is temporarily lowered to \$0	
June 2020	The Australian Government announces a new 'national security' test for investments that are not otherwise screened through the national interest test, stronger penalties, compliance and enforcement powers and other measures to improve the integrity of the foreign investment laws. The Government announced its intention to introduce the new arrangements from 1 January 2021, subject to passage of the legislative amendments.	

Table C.4 Policy screening thresholds changes

<i>Date</i>	<i>Effect</i>	<i>Restrictiveness</i>
Sep 1999	Screening thresholds raised to \$50 million from \$5 million (for general investment), \$3 million (for rural businesses) and \$20 million (for offshore takeovers of companies with less than 50% Australian assets)	↓
Oct 1999	Foreigners and foreign airlines allowed to acquire up to 100% of Australian domestic carriers, unless contrary to national interest	↓
May 2000	Foreign airlines permitted to acquire up to 49% of Australian international carriers (except for Qantas — chapter 3)	↓
Mar 2004	Mechanism added to exempt acquisition of shares by foreign custodians on behalf of Australian investors	↓
Jan 2005	Australia-US Free Trade Agreement raised threshold for US investors to \$50 million for government investors or investment in sensitive sectors or \$800 million in any other case, with thresholds indexed annually	↓
Nov/Dec 2006	General threshold raised from \$50 million to \$100 million (including for US investment in sensitive sectors). Threshold for offshore takeovers raised from \$50 million to \$200 million	↓
Apr 2007	Removal of foreign ownership restrictions on regional/suburban and metropolitan newspapers and broadcasting	↓
Sep 2009	General screening threshold raised from \$100 million to \$219 million and indexed to inflation Investors no longer required to notify of creation of new Australian business	↓
Mar 2013	Screening threshold increased for investment from New Zealand, from \$248 million to \$1078 million (under the Australia-New Zealand Closer Economic Relations Trade Agreement Investment Protocol)	↓
Dec 2014	Screening threshold for non-sensitive sectors increased from \$252 million to \$1094 million for investment from Korea under a new free trade agreement	↓
Jan 2015	Screening thresholds for non-sensitive sectors increased from \$252 million to \$1094 million for investment from Chile and Japan under new/revised free trade agreements	↓
Dec 2015	Introduction of application fees and stricter penalties (including criminal sanctions) for breaches of obligations and restrictions Screening threshold for private Chinese companies in non-sensitive sectors raised from \$252 million to \$1094 million under a new free trade agreement	↑ ↓
Mar 2016	Commonwealth foreign investment review rules extended to the sale of state, territory or local government owned infrastructure assets	↑
Jul 2017	Improved transparency, consistency and equity of fees, with reduced complexity	↓
Dec 2017	Amendment to Australia-Singapore free trade agreement raised screening threshold in non-sensitive sectors from \$252 million to \$1094 million; also raised thresholds for agricultural land and agribusiness	↓

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